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Review

Financial crisis and its remedies

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Global financial markets are showing strains on a scale and scope not witnessed in the past three-quarters of a century. What started with elevated losses on U.S. subprime mortgages has spread beyond the borders of the United States and the confines of the mortgage market. Many risk spreads have ballooned, liquidity in some market segments has dried up, and large complex financial institutions have admitted significant losses. Bank runs are no longer the subjects exclusively of history. These events have challenged policymakers, and the responses have varied across region. The European Central Bank has injected reserves in unprecedented volumes. The Bank of England participated in the bail-out and, ultimately, the nationalization of a depository, Northern Rock. The U.S. Federal Reserve has introduced a variety of new facilities and extended its support beyond the depository sector. These events have also challenged economists to explain why the crisis developed, how it is unfolding, and what can be done to develop increased awareness about the current financial crisis, to facilitate the discussion regarding myths and realities about the crisis, to discuss possible ways to bring out the Indian economy out of this crisis and to discuss the measures available to insulate the economy from further vulnerability to this crisis.

Key words: Global financial markets, financial crisis, European Central Bank.

INTRODUCTION

Former Indian finance minister Yashwant Sinha said in June, "I believe that the international institutions we have at the moment are woefully inadequate in dealing with the global challenges. There is a major regulatory failing in the US. What is the IMF doing about the US? Nothing."

The IMF's (Internatinal Monetary Fund) predictions in April of $1 trillion in losses from the sub-prime crisis, ridiculed by some, may turn out to be too low. But in fact over time the IMF has been very unsure of whether the crisis is starting or ending. Over the last 12 months, its prognosis has flip-flopped more times than can be counted. For example in August, 2007, when credit markets first started to contract in the US and UK, the IMF sought to calm fears by asserting that the credit risk was "manageable". The tone was the same heading into September, however by the time the month was through Rodrigo de Rato, then head of the Fund, acknowledged that although it would take some months for the impact to become evident they "[did] not see a
prompt resolution of the credit crisis."

By December a new managing director had come to the Fund, and magically it seemed no crisis existed. Dominique Strauss-Kahn was quoted by an Italian newspaper as saying "There is no deep crisis on the markets." This continued from May through July as Strauss-Kahn made declarations that "there are good reasons to believe the worst news is behind us". By the end-July release of the Global Financial Stability Report, press reports interpreted the IMF's stance as saying the credit crunch was still worsening, but that it would be over in 2009.

So where do we find ourselves one year on? The recent collapse of US investment bank Lehman Brothers and the buy out of another investment bank Merrill Lynch raises fears that we are, if anything just entering round two. Strauss-Kahn now humbly admits "I cannot say the worst of the financial crisis is behind us."

The turbulent months of August and September saw the US Treasury nationalise two giant mortgage guarantee companies and the world's largest insurance company, on top of numerous bankruptcies, financial sectors mergers in the US and UK. In each case of major policy intervention, the IMF nodded its approval after the US government announced its plans. Strauss-Kahn welcomed the late September proposed $700 billion financial bailout package from the US Treasury despite not knowing any details of how the bailout would be conducted and before the US congress had considered and approved

the deal. Strauss-Kahn seemed to ignore the criticisms leveled at the package by commentators from the left and right.

THEORETICAL APPROACH

For too many years financial market participants were used to a macroeconomic environment with high global output growth, low inflation and very low interest rates. Macroeconomic policies led to global and domestic imbalances which became increasingly unsustainable with debt financed over-consumption in one region and high savings in other regions. An overall benign macroeconomic environment led to (i) A general carelessness or a tendency to under-price risks and (ii) To a search for yield which in turn accelerated financial innovation.

The main manifestation of financial innovation had been the extraordinary expansion of credit risk transfer instruments which permitted the transfer, hedging and active trading of credit risk as a separate asset class. The financial instruments became increasingly complex and the speed of innovation amplified. Examples included credit default swaps (CDSs) and, in particular, structured credit products, such as collateralised debt obligations (CDOs), backed both by cash instruments, such as primitive securities, loans or asset-backed securities, and by derivative claims, such as CDSs and CDOs themselves.

The expansion of these products had both contributed to, and been supported by a strengthening of the originate-and-distribute (O and D) business model of financial intermediation. Rather than holding the credits they originated, credit institutions increasingly sold them off - possibly after repackaging them - to the capital market.

The advocators of the new financial instruments praised them as facilitators of an efficient distribution of risk. However, these instruments do not eliminate credit risk. Therefore, the high speed of innovation and the instruments' increasing complexity as well as the exploding trade also pointed to potential weaknesses that required significant vigilance by all parties involved, that is, originators, investors, rating agencies and supervisors. Thus, "creative destruction" turned into "destructive creation".

However, the crisis proves that the institutional framework has not kept pace with the fast speed of innovation. In particular, the lack of adequate checks and balances at all levels of control has led to increased vulnerabilities and risks.

Financial institutions

Weak risk and liquidity management frameworks; specifically, management and supervisory boards of the financial institutions did not live up to their ultimate responsibilities as regards risk management; risk management models did not keep pace with the increasing complexity of financial instruments and did not properly take into account the potential illiquidity of some market segments;

Rating agencies and external auditors: Their models and assessments failed to adequately evaluate the financial risks attached to financial innovations;

Supervisory authorities: No serious attempts were made to stem against the trend of searching for yield that accelerated financial innovation in good times; no adequate monitoring systems were in place in particular as regards ultimate exposure to mortgage backed securities and other new complex structured financial products and as regards off-balance sheet entities;

External environment: At the global level, the outlook for advanced economies has worsened significantly while the financial crisis has started to spread to emerging markets. In 2009, all major advanced economies will experience weak or zero growth at the same time. The outlook for the US economy remains very gloomy. Forecasts by international organisations see 2009 average growth near or below zero. The growth outlook for emerging market economies has weakened dramatically. The IMF and the EU Commission see global growth at 2.2 and 2.3% in 2009, respectively, after 3.7% this year.

The depth and duration of the global economic downturn will crucially depend on the development of the financial crisis. At the current juncture, market volatility and uncertainty remain extremely high.

Global inflationary pressures are easing due to the global economic downturn and the falling commodity prices. All in all, the global inflation outlook has improved.

The significant intensification of the financial crisis since mid September has greatly affected the outlook for short-term economic growth in the euro area. However, the economy was already hit by significant commodity price increases and the ongoing correction in the housing market in some euro area countries.

After two negative quarters of economic growth, GDP growth in the 4th quarter 2008 and in the coming quarters will be very weak. This reflects a subdued outlook for external and domestic demand and tighter financing conditions.

The assumptions for the December, 2008 Broad Macroeconomic Projection Exercise had to be significantly revised compared to the September, 2008 ECB Staff Macroeconomic Projection Exercise. However, it should be born in mind that uncertainty surrounding the projections is particularly high at this juncture.

According to the projection results for the euro area, GDP growth is projected to experience a protracted period of subdued growth (2008: 0.8 - 1.2%; 2009: -1.0 – 0.0%; 2010: 0.5 - 1.5%), with dampened domestic and external demand. The European Commission forecasts growth near zero in 2009 and quarterly growth rates to

remain very low until Q2 2010. More recently, the IMF and the OECD see the euro area in recession in 2009 (around -1/2%). Uncertainty is extremely high and risks are further to the downside.

Inflationary pressures and risks in the euro area have diminished amidst weakening demand, declining commodity prices and receding pipeline pressures. Since July this year, when HICP inflation was at 4%, inflation most recently has substantially declined, reading 2.1% in November. In this process of disinflation we might even see negative inflation rates for a couple of months in some regions of the euro area. Over the policy-relevant horizon, inflation rates are expected to be in line with price stability, supporting the purchasing power of incomes and savings. The Euro system staff projections foresee annual HICP inflation rates of between 3.2 and 3.4% for 2008 and declining rates of between 1.1 and 1.7% for 2009. Monthly inflation is expected to reach a trough in summer before rebounding again at the end of 2009. For 2010, HICP is projected to lie between 1.5 and 2.1%.

In this context, some financial analysts discuss the risk of deflation. However, this term should be used with caution and not be mixed up with disinflation. It is important to distinguish between.

On the one hand “strong disinflation” or “temporary and mild deflation”, which is of a transitory nature and which stems primarily from substantial declines in energy prices? On the other hand, genuine “deflationary dynamics”, which are characterized by their persistent and self-sustaining character, their broad based effects across most price components and their entrenchment in expectations.

However, it should be stressed that risks appear very limited given the continued anchoring of longer-term inflation expectations at levels consistent with price stability, wage and price stickiness and the still sustained pace of monetary dynamics.

By contrast, upside tail-risks to inflation receive less attention but may be more relevant and a stronger source of concern in the medium to longer term.

Various estimates of underlying broad money point to a sustained but moderating rate of monetary expansion in the euro area. Monetary trends therefore support the view that inflationary pressures are diminishing further, with some risks remaining on the upside in the medium to longer term. The latest monetary data up to the end of October, 2008 point to a continued moderation of the growth rate of loans to the non-financial sector. So far, the hard data does not support the view of a drying up in the availability of loans.

REMEDIES TO OVERCOME FINANCIAL CRISIS

There is no need for a new global financial system (Breton-Woods II) or for creating new international institutions from scratch. Rather, there is a need for strengthening the existing institutional framework by enhancing those general principles that ensure a smooth functioning of market economies: stability-oriented macroeconomic policies; high competition on all markets; the protection of property rights; freedom of contract; and unlimited liability.

As regards macroeconomic policies, they have to be medium term oriented and geared towards price stability and sound public finances. The commitment to price stability and sound public finances is the best contribution monetary and fiscal policies in the euro area can make to financial stability. There is no trade-off between price stability and financial stability and there is also no trade-off between sound public finances and financial stability.

As regards the institutional framework for the financial sector, we have to accept that even the tightest regulation cannot prevent a financial crisis. However, it is clear that the benefits of tighter regulation are larger than thought some quarters ago. Hence, there is a need for a realistic assessment of the costs and benefits of tighter regulation. New regulation should set general principles rather than drawing up long lists of discretionary measures, which are necessarily incomplete and invite renewed regulatory arbitrage.

New regulations should

1) Not cover all possible states of nature but rather provide automatic stabilizers for the financial system in general terms.
2) Strengthen incentives that improve the disciplining forces of competition.
3) Discourage “short-termism” and promote a medium to long-term attitude of financial agents towards success and stability.
4.) Not prevent financial innovation as it is important for growth and employment,
5) Strengthen at the same time the concept of liability and responsibility. It must be clear for those who engage in risky activities that they will be held accountable if these risks materialize.

There are already some important initiatives that provide some guidance for consistent regulatory standards on an international basis:

1) The G20 has approved a set of international standards and codes for a sound regulatory framework. However, implementation is lagging behind.

2) The Financial Stability Forum has already developed recommendations for the resilience of markets and institutions that have caused the financial turmoil.

There are in particular five areas of concern that should be addressed to strengthen the institutional framework for the financial sector:

Risk management of banks: Both bank management and

supervisors will have to play a more active role in scrutinizing risk management practices (internal checks and balances, clear lines of responsibilities, etc.), especially with regard to off-balance sheet entities and structured products. This should hold true not only in times of crisis but maybe even more important in good times when risks are less obvious.

Management of liquidity risk: Bank management should enhance their liquidity management practices to address the liquidity risks in their day-to-day business along the line of the “Principles for Sound Liquidity Risk Management and Supervision” provided by the Basel Committee.

Credit rating agencies: Rating methodologies failed to capture risks embodied in structured products and investors relied too heavily on those external ratings. Rating agencies should enhance their transparency and should comply with relevant codes of conduct. More differentiated rating systems for structured products should be adopted. Conflicts of interest are to be avoided which are in particular acute when a rating agency also offers consulting services.

Valuation, disclosure and accounting: Weaknesses in accounting standards and gaps with regard to valuation of structured products contributed to the current crisis. Banks will have to develop robust pricing, risk management and stress testing models and improve disclosure practices. Supervisors and accounting standard setters should advance the transparency and the disclosure standards for off-balance sheet vehicles. They should further reassess the valuation of assets, with a special focus on the mark-to-market approach given its potentially procyclical effects.

Strengthen capital adequacy: Supervisors did not adequately account for the risks associated with new complex financial instruments. Some financial engineering in recent years focused on repackaging weak credits into high-rated securities, receiving a favourable risk weighing for capital adequacy standards. The respective prudential norms and rating schemes should be reassessed also with a view to make the financial instruments less complex. The O and D business model of financial intermediation should not disappear but it should become more transparent. It should also be considered whether the originator should always keep a certain percentage of an offloaded credit package on the own balance sheet. In order to increase the capital buffers that banks need to hold with regard to illiquid structured products and off-balance sheet activities, the capital adequacy provisions within the Basel II framework should be also enhanced in these areas.

Conclusion

The current global financial distress and the economic downturn pose challenges of a significant and unprecedented nature to the ECB, other central banks and policy makers around the globe.

During the financial turmoil the euro area, the monetary union and its institutional set up have proved their resilience and the capacity to act decisively and promptly. National measures have been co-coordinated in a pragmatic manner with a view to enhancing their effectiveness through mutual reinforcement.

All this is not self-evident. We should not forget how Europe would look today without the euro. The euro area countries would be significantly worse off. Multiple crises would arise simultaneously: currency crises would go hand in hand with banking crises and real economy disruptions at country level, potentially ending up in political tensions between countries.

By eliminating the exchange rate channel, the euro has mitigated the risk of contagion stemming from national economic or financial crises. In this sense, the euro has been a very important stabilizing element in difficult times.

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