“The Global Financial and Economic Crisis”

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14th European Forum, Berlin

14-15 November 2008

Causes and Consequences

1. With inflation kept down by increases in global aggregate supply, it was possible for most of this decade to have highly stimulatory monetary policies worldwide. Against this background, financial innovation and lower credit standards also encouraged further credit growth which, for a time, led to stronger economic growth. However, this so-called “Great Moderation” was always threatened by a prospective rise in inflation, if demand eventually came to outstrip supply, and by growing imbalances within the global economy.
2. While all linked in some way to the expansion of debt, four particular imbalances can be identified. First, asset prices rose to levels seemingly not justified by underlying fundamentals. Second, the ratio of consumption to GDP in many countries with sophisticated financial systems rose to unprecedented levels, as did fixed investment in China. Third, global trade imbalances widened. And finally, the exposure of the financial system to risks of various sorts increased markedly as leveraged speculation soared. However, the precise extent and the incidence of these exposures became increasingly hard to determine given the growing complexity of new, securitized products.
3. There was a widespread failure to see the risks involved in these developments. Borrowers, lenders, regulators and central banks in the Advanced Market Economies all tended to extrapolate the good times, rather than seeing that the probability of an eventual mean reversion was steadily rising. Even those who foresaw trouble felt there was little hope of resisting the “boom”, and that policy easing would suffice to moderate the “bust”.
4. The authorities in the Emerging Market Economies erred further in resisting appreciation of their domestic exchange rates through easy

monetary policies and exchange rate intervention. This had undesirable effects (rising inflation and growing imbalances) both at home and abroad.

5. As a result of all these developments, the outlook for the global economy is grim. Should a number of these imbalances unwind simultaneously, which looks increasingly likely, there is a significant chance of a deep and protracted global recession.
6. While conditions in financial markets seem to have improved somewhat, a slowing real economy will feed back on the financial system in many negative ways. In turn, this will lead to still tighter credit conditions and a further worsening in the economic outlook. This process might even culminate in a debt-deflation arising from the interaction of high nominal debt levels and falling prices.
7. The implications of these economic developments for social and even political stability in a number of countries should not be underestimated.

Suggested policy responses

1. Crisis management must be the first priority, not least because it is likely to prove very difficult. In particular, traditional macroeconomic instruments may have lost their effectiveness as household debt levels have risen over the years, and efforts to write off debts and recapitalize financial institutions might also prove difficult to implement. As a result, it will likely be necessary to use all the instruments available, and to use them aggressively, to have the desired effect on aggregate demand. This said, it must also be recognized that necessary policies directed to crisis management might also embody a significant degree of moral hazard looking forward.
2. This moral hazard issue implies that efforts to strengthen the system to prevent a repeat of today's troubles should also receive high priority. This could help reduce the dangers of moral hazard. In any event, crises often provide the opportunity for far-sighted reforms that might not be politically feasible at other times.
3. The misuse of new instruments and procedures in the financial system triggered the current crisis but was not its main cause. Thus regulatory and other measures designed to deal with such issues should be carefully thought through. Old abuses will not look tempting for many years, so

there is time for careful reflection on how fundamentally useful innovations might be preserved and improved.

4. To address the fundamental cause of the present crisis, excessive and imprudent lending, individual countries need to introduce a new macro financial stability framework. Its purpose would be to ensure that both monetary and regulatory instruments are used to lean against the upswing of the credit cycle. At the same time, it must be accepted that moderate economic downturns, from time to time, might also have a role to play in moderating the appetite for risk that has contributed to our current problems.
5. A new international monetary system must also be agreed upon, one that will prevent trade imbalances from rising again to dangerous levels. A process to develop such a system should be put in place as soon as possible since it will take considerable time for reflection, agreement and implementation. Recall that Bretton Woods took years.
6. Recognizing that all of the above suggestions will only moderate crises, not exclude them, efforts should be made in advance to increase our capacity to manage crises. Some of these measures are national in scope but many have an international dimension since national measures can have spillover effects on others; accordingly, we need agreements on information sharing, how to wind down internationally active and complex financial institutions, burden sharing given debt write offs, appropriate levels of deposit insurance and other guarantees.etc.
7. With respect to all of the above recommendations, there will be need for enhanced international cooperation. Further, internationally coordinated statements about planned policy actions will be crucial in restoring public confidence in the stability of the financial system.

A special role for Europe in fostering international co operation ?

1. In forging the European Union and the euro area, European countries have shown an unprecedented capacity for international cooperation; in particular, the willingness to cede elements of national sovereignty to achieve common purposes. They can now credibly apply this experience to global issues and can lead by example. Moreover, the rise of powerful emerging market economies, and the current difficulties of the United

States, provides a window of opportunity for Europe to catalyze many needed changes.

2. Europe could make a major contribution to **institutional reform** by agreeing to have only one representative at a revamped G7/8, and on the boards of the Bretton Woods institutions. This would leave room for new players and would likely increase the influence of a currently divided Europe, relative to other important players. This would enhance both the legitimacy and operational independence of the Bretton Woods institutions, both attributes being required if these institutions are to play meaningful roles in international cooperation going forward.
3. With respect to **crisis management**, it would be exemplary to agree a common set of European principles, preferably within some more global framework. Very important would be further agreements on exit strategies and ways to mitigate moral hazard going forward.
4. With respect to **planning for further crises**, European countries could also show the way by agreeing on a common position among themselves on how deposit insurance should be structured, how large and complex financial institutions should be wound down, etc. Ideally, these agreed positions would then be taken to the broader global scale, with a view to still further negotiation.
5. Finally, with respect to **crisis prevention**, European countries should move quickly to contribute to effective “colleges of supervisors” for large internationally active banks. In this process they should make clear that the purpose of the exercise is to ensure prudent behavior with a view to minimizing systemic risk. An explicit statement rejecting the “championing” of national flagships would also be welcome, since such competition only encourages risk taking.