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TEN YEARS ON, IN UNCHARTED WATERS

Relevant for: International Relations | Topic: Effect of policies and politics of developed countries on India's interests

Economists thrive on crises. 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. The crisis, 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. Have these made the world any safer? Unlikely, as we shall see later.

The crisis of 2007 had multiple causes. 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. All of them undoubtedly contributed their part. But each has happened before without on its own bringing on a global economic crisis.

Everything you need to know: When the world collapsed around Lehman Brothers

Most of the blame for the implosion of the financial sector in 2007-08 lies elsewhere — in a failure of regulation. This failure 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. The boards of banks did not exercise adequate oversight.

Lehman's profound impact on economy

These failures were not confined to the U.S. They infected banks in Europe and some in Asia as well. These banks were not merely exposed to American assets. As economic historian Adam Tooze has pointed out in a recent book and in an article in *Foreign Affairs* (September/October 2018), they had financed these assets through large borrowings in the American wholesale market. The sub-prime problem was thus not just an American problem but a problem for large chunks of the global banking system.

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.

How did such a colossal failure of regulation occur? 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.

The 'revolving door' plays havoc with regulation. It must also explain the total lack of accountability of bankers for the havoc they created. No top banker has been prosecuted or jailed. Instead, banks have paid up hefty fines for assorted violations, the fines coming from the pockets of shareholders.

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.

Is the world safer from a financial crisis today? 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.

That is because three issues remain significantly unaddressed. 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. Concentration in banking has increased.

Why is external debt a cause for worry?

Second, the size of debt in various forms in the world economy. A crucial aspect of the financial crisis was the build-up of private debt, that is, the debt of households and non-financial firms. Two Chicago economists, Atif Mian and Amir Sufi, argued in a well-received book, *House of Debt*, that the expression 'financial crisis' was something of a misnomer. The key driver of the recession in the U.S. was the rise in household debt and the consequent drop in household consumption. This does not negate the view that regulatory failure was the principal cause. It only means that regulation must address growth in credit as well as the flow of credit into sectors such as real estate.

In the years following the crisis, private debt has fallen but government debt and corporate debt have risen. The former head of the U.K.'s Financial Services Authority, Adair Turner, says that total debt — government, corporate, and household — as a percentage of GDP is higher than ever before (*Financial Times*, September 11). 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. From time to time, the U.S. unleashes a flood of dollars at low rates. The world laps up the cheap finance. Then, the U.S. raises interest rates. Other economies find themselves staring at huge debt repayments. Further, the dollar remains the reserve currency of the world. The U.S. can borrow to the hilt but the dollar will not depreciate, it may even appreciate!

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. Economists are free to draw their lessons from financial crises but the world is ultimately shaped by political and business interests, not by economists.

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