Effects of Global Financial Crisis

The roots of the current global financial crisis can be traced back to the fallout of the US subprime mortgage lending, which started in early 2007. Without hesitation, it spread into other markets and economies via a combination of market failures and regulatory weaknesses.

In general, market failed because of poor corporate governance and incompatible executive remuneration structures. Moreover, the lack of transparency in trading procedures, financial instruments, and balance sheet positions of major financial institutions also exacerbated market failures. In regulatory terms, 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 distrusts between financial market participants in September 2008. In turn, this had led to complete breakdown of short-term financial transactions in leading advanced and emerging market economies, and subsequently, meltdown in global securities exchanges. With the freezing of interbank 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 needs to recapitalize financial intermediaries either through direct capital injections or merger and acquisition plans. Furthermore, active global coordination programs 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 period. 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 slowdown along with falling price levels, central banks may lower their official policy rates. At the same time, monetary authorities may also recourse to loosening 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 2008 has brought about massive capital outflows from emerging market economies. Volatile capital flows have also led to wild exchange rates fluctuations across the world. Exchange rate depreciation, due to capital repatriation from less-developed countries, may tend to boost trade figures of the host nation. However, exchange rate devaluation policy may backfire as other countries may also pursue competitive devaluation.

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 expected to fall in the medium term. The strength and characteristics of the financial sector as well as the transmission process are other important factors determining the success of monetary policy. 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 tradeoff 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 necessary task of the monetary regulator.

Similarly, large infrastructural 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 in order 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 government may implement special credit management or evaluation policies for sectors badly affected by the global financial turmoil. There may also be especially useful in encouraging individual banks to restructure loans for companies affected by the financial crisis. By doing so, countries may overcome the aggregation bias which tends to mask macroeconomic policies. More effective screen procedures will tend to reduce the effects of moral hazard across different industries and sectors.

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.