Analysing the role of government intervention in resolving the financial crisis

Government

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Abstract

This paper examines the role of government interventions in resolving the financial crisis. This paper supports the argument that government interventions had helped to lessen the impacts of the crisis and that policy measures are important in ensuring sustainable economic growth (as espoused by Keynesian macroeconomic theories). Evidence is presented to support the arguments of this report. Some recommendations on how the government can improve its policies are also given based on the lessons learned from the crisis.

Introduction

The 2007-2008 global financial and economic crisis and the interventions of various governments to stabilize their economies have generated fierce debates and controversies regarding the benefits of the free market system and the function of government in the economy. Many economists and business experts contend that government intervention had caused and prolonged the recent financial crisis; however, supporters of Keynesian macroeconomics argue that active government intervention in the marketplace and monetary policies were necessary to survive the crisis. Moreover, supporters of the free market system assert that without government intervention, the forces of demand and supply will help the economy to adapt to the financial crisis and inevitably correct the imbalances. On the other hand, proponents of intervention contend that the financial crisis and subsequent recession are evidence of marketfailure;

therefore, the government had to step in to mitigate the adverse consequences of such failure (Aikins, 2009).

This short paper examines the 2007-2008 global financial and economic crisis based upon the perspective that government policy interventions had helped to reduce the riskof making the financial crisis even worse. This paper supports the argument that the role of the government had contributed to stabilizing the economy during the crisis. Evidence is presented in this paper supporting this claim. Moreover, this paper argues that the market and the government must mutually co-exist for the benefit of society. Some recommendations are also provided on how governments should act to avoid future crisis.

The purpose of government interventions

The ultimate objective of government interventions was to normalize credit conditions and resume sustainable economic growth. These interventions had three main objectives: (Psalida, et al., 2009)

Containing and reversing the strain in financial markets by providing liquidity and funding guarantees

Removing impaired assets from banks' balance sheets

Recapitalizing and restructuring viable illiquid financial institutions

To reach these objectives, government authorities implemented several policy measures. These include: (Psalida, et al., 2009)

Unparalleled sums of liquidity injections, available to a widened set of counter-parties

Reducing credit through the purchase of credit instruments (e. g. commercial paper and corporate bonds); or using these as guarantee for non-recourse cash endowment

Providing guarantees to bank liabilities

Capital injection/recapitalization of financial institutions

Relieving banks of impaired assets

Figure 1. Time Pattern of Crisis Measures

Despite the criticism that the interventions have intensified the weight of public debt and the extent of government dependent accountabilities, it cannot be denied that these interventionist policies have lessened the real effect of the financial crisis (Laeven & Valencia, 2012). The main objective of the interventions, which was to stop the financial panic and bring back normality to the financial markets, was achieved. The intervention programmes were successful in helping financial markets to return to their normal functions (Webel & Labonte, 2010).

A more realistic way of evaluating whether the government had succeeded in its intervention efforts is to determine if financial normality was reinstated at the least cost to taxpayers. At the height of the crisis, non-intervention would have likely resulted in more costly losses for the national economy in terms of productivity and this would have worsened the government's finances (Webel & Labonte, 2010). Non-intervention could also prolong the crisis as successive bankruptcies may contract the economy.

The government receives assets in return for interventions (i. e. recapitalization, guarantees, etc.). These assets provide the government with legal entitlement to the potential revenues of the companies it had assisted (Webel & Labonte, 2010). Therefore, the interventions do not actually cause permanent losses to the government's finances. These arguments put to rest the claim that the interventions should have not been made at the cost of taxpayers'money.

In defence of bailout packages

Due to fears that the financial crisis would spiral out of control in September 2008, the leaders of western developed countries undertook radical measures to rescue financial institutions, which were in danger of collapsing. The US, in particular, embarked on the most extensive government economic interventions with the doling out of huge bailout packages for its beleaguered financial institutions. It was estimated that the US government spent USD $1. 3 trillion on bailout packages; while European countries spent an aggregate amount of USD $2. 8 trillion to rescue their financial institutions. This amounts to a combined total of USD $4. 1 trillion (Aikins, 2009).

The popular sentiment towards these government sponsored bailout packages is that it created a moral hazard because it only served to increase the risk-taking of banks. The argument is that by failing to penalize banks for their improper practices, banks may make riskier investments because their leaders believe that the government will always bail them out during the crisis (Poctzer, 2010; Norberg, 2009). Although this sentiment is

understandable (and may even prove to be true in some cases), the primary purpose of the bailout packages was to restore confidence in the financial system in the short-term (Psalida, et al., (2009).

From this standpoint it is apparent that government intervention had worked to stop or, at the very least slowdown, the crisis from escalating. More importantly, the public wanted to see that their government was doing something to resolve the crisis. Leaving the market to run free, in anticipation that it would inherently fix the imbalances by itself, might be difficult for most ordinary citizens to understand. At that point in the crisis, the lack of action by the government would be met with even more criticism by the public. (Aikins, 2009)

Table 1. US Commitment to Financial Sector Bailout in USD $ billions (as of Nov 13, 2008)

ProgramAmountDescription

Troubled Asset Relief Program (TARP)700. 00Intended for purchasing troubled mortgage-related assets; later on was used for cash injections on banks

Commercial Paper Funding Facility243. 00The Fed purchases commercial paper (short-term debts) from banks to help fund daily operations

Fannie Mae/Freddie Mac200. 00The Fed took control of mortgage firms; cash injections are used to keep them afloat

AIG112. 50Excludes $40 billion taken out from TARP; AIG successfully negotiated a bigger bailout package with easier terms

Bear Sterns29. 00Special lending facility that guarantees losses on portfolios

of investment banks

FDIC (Federal Bank Insurance Corporation) Bank Takeovers13. 20The FDIC put up this fund to cover deposits on failed banks

TotalUSD $1. 3. trillion

Source: (Aikins, 2010)

Table 2. Western European Nations' Commitment to Financial Sector Bailout in USD $ billions (as of Nov 13 2008)

CountryAmountDescription

United Kingdom743. 00Half of the package is used to guarantee bank to bank borrowing; 40% was allocated for interim loans; and 10% is used for recapitalization

Germany636. 50Most of the amount is for undertaking medium-term bank borrowing; 20% is for recapitalization

France458. 30Majority of the fund is to secure bank debts; $50 billion is for recapitalization

Netherlands346. 00For guaranteeing bank to bank borrowing

Sweden200. 00For credit warranties

Austria127. 30For bank acquisitions, inter-bank borrowing, bank bond insurance guarantees

Spain127. 3For bank acquisitions; inter-bank borrowing; bank bond insurance guarantees

Italy51. 00Purchasing of bank debts

Other countries110. 60

Total EuropeanUSD $ 2. 8 trillion

Source: (Aikins, 2010)

Poctzer (2010) also found that despite the possibility of increased risk-taking by banks after being bailed out, there are indications that recapitalization is an effective tool for stimulating lending, but it is most helpful for bigger banks and when implemented in combination with an asset purchase program. Figure 2 shows the comparison of risk taking by recapitalized and non-recapitalized firms. It can be observed that recapitalized firms tend to be more risk-taking compared to non-recapitalized firms. On the other hand, Figure 3 shows that recapitalized firms tend to increase their lending activities compared to non-recapitalized firms. Figure 4 illustrates that asset transfer firms have the most lending volume compared to recapitalized and non-recapitalized firms.

Figure 2. Time Series of Risk Measure between Recapitalized and Non-Recapitalized Banks

Figure 3. Time Series of Average Lending Volume between Recapitalized and Non-Recapitalized Banks

Figure 4. Time Series of Average Lending Volume between Recapitalized Banks, Non-Recapitalized Banks, and Asset Transfer Firms

Lessons learned

The bailout packages served their purpose at the height of the crisis. However, the government cannot always employ capital injections to rescue financial institutions as this have implications not only on the issue of moral

hazard (Poctzer, 2010), but more importantly, these have major impacts on the national budget and taxpayers' trust (Webel & Labonte, 2010). Breitenfellner & Wagner (2010) recommend that only financial institutions that are non-liquid but solvent should be saved and the institution must pay significantly for the bailout. The authors also argue for stricter regulation, enhanced risk awareness, more advanced risk management, and a more effective alignment of interests among stakeholders.

Gertler, Kiyotaki & Queralto (2011) argues that a bank's decision over its balance sheet is highly dependent on its risk perceptions, which in turn are dependent on major disruptions to the economy and their expectations on government policies. The authors also found that the incentive effects of risk taking may potentially diminish the benefits of credit policies that are intended to stabilize financial markets. It is therefore important to design appropriate and efficient macroeconomic policies to mitigate moral hazard costs.

The role of the government in managing the economy cannot be overlooked. The lack of a suitable economic policy and regulatory structure will make the financial system vulnerable to recession and may jeopardize the stability of the whole economy. The government therefore should establish appropriate economic and regulatory policies: (a) to defend against market failure; (b) avoid political and institutional intrusions in the regulation of financial institutions; and (c) avert supervisory tolerance, arbitrage, and capture (Aikins, 2009).

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