

Introduction formulate  
measures that would  
avert future crises



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## **Introduction**

The US led global financial crisis that struck in 2007 and persisted through 08 and 09 adversely affected the stability of the global economy. The impact of the crisis escalated far beyond its point of origin (US) and affected the countries around the world while spilling over from the financial system into the real economy. The implications of the crisis were wide ranging and still difficult to conceptualize. This has led to extensive analysis of the financial crisis by policy makers and financial analyst in a bid to develop and formulate measures that would avert future crises and stabilize the global economy. While numerous claims have been put forth to explain the causes of the 2007-2009 financial crisis, there is almost a universal agreement that the major causes of the financial crisis was the combination of a credit boom and a housing bubble that took place in the United States. The post 2007 crisis consequently features the establishment of numerous regulatory initiatives offering diagnoses and presenting recommendations for financial stabilization. Through literature review, the research paper analyses the varying causes that the crisis has been attributed to, the policies which various major governments sought to implement in response to the crisis, the effectiveness and failures of such policies.

The research paper further proposes the alternative areas of focus that may serve to avert future crisis in order to achieve consistent financial stability.

## **Reasons for the 2007-09 global financial crises**

The decline in the US housing market resulting from the failure of sub prime mortgages and mortgage backed securities coupled with an ensuing credit

boom marked the beginning of the financial crisis (Canster Cannex 2011).

The housing market suffered a major blow as the majority homeowners defaulted on the (sub prime) loans. As a consequence of borrowers defaulting on loans, the financial institutions faced a major challenge as they repossessed the property at a loss which led to a liquidity crisis in banks and their lending capacity was consequently diminished (Obersteiner 2011).

In addition, there was lack of confidence by US investors which led to emergence of a credit crunch. The consumer confidence was limited due to widespread uncertainties in the economy. While the housing bubble and the credit crunch in United States has been widely attributed as the major cause of the 2007 financial crisis, a valid argument still stands that the crisis resulted from poorly regulated lending by financial institutions. The collapse of major financial institutions led to widespread panic as governments across the globe struggled to rescue the major financial institutions in their regions from collapsing. The Australian government launched the stimulus packages which were aimed at rescuing the collapsing economy while the government of United States proposed a \$700 billion rescue plan (Obersteiner 2011). This was met with substantial opposition by congressmen who felt that such spending of taxpayers' money to rescue Wall Street investment bankers was not justified. Metodi Lazarov (2009) argued that if liquidity was the actual cause of the global financial crisis, then providing more liquidity through reduced interest rates that made borrowing easier would have been appropriate in solving the situation. He cites the ignorance of major financial institutions on their own business models of secularization as the major cause of persistent financial crisis.

He further attributes the crisis to globalization, financial innovation and asymmetry of information (Lazarov 2009). Lazarov suggests that the presence of liquidity effects increases the chances of systemic breakdown of any given connectivity between financial institutions which may have caused the crisis. While he agrees that the financial system contained the effects from the housing bubble, he emphasizes on the need for a new and advanced regulatory framework which will shape the financial systems in the future.

Fiscal measures are also among the main reasons why investors ran into large risky market such as sub prime which has been cited as a major cause of the 2007 financial crisis. The US government's move to issue mortgage backed securities coupled with the relative decline in prime mortgage set the stage for the onset of the financial crisis (Lazarov 2009). This saw a significant increase in sub prime mortgage lending which was not in adherence to the government and financial regulations. Further, nationalization of the Fannie Mae and Freddie Mac led to increased investor confidence which led to over reliance of market participants on government guarantees (Lazarov 2009).

## **Responses of Major Economies to the Global Financial Crisis**

### **Australia**

In Australia, the financial crisis struck at a time when the local economy was suffering from massive inflation. In response to these challenges, the Australian government announced its stimulus packages worth \$ 10.

4b and the government further sought to guarantee the bank deposits (Canster Cannex 2011). The economic stimulus played a major role in improving the economy which was suffering from recession and incorporated government transfer payment to consumers which in turn increased sales especially over 2008 Christmas period. The government also provided assistance to various sectors in the economy such as the automotive industry since lenders had lost confidence in the market leaving banks as the only credit providers. As the condition of the economy continued to worsen in the beginning of 2009, the government announced a second stimulus package where the government injected \$ 47 billion to boost the economy which was then allocated to ailing sectors such as education, housing, infrastructure, small businesses, as well as provision of cash bonuses (Canster Cannex 2011). Consequently, the country suffered less impact of the global financial crisis relative to other major economies of the world. Financial experts argued that the county's economy was more insulated but evidence of general slowdown in the housing market, and unemployment was still evident in the Australian economy and some questioned the massive government packages claiming that they would haunt the country's economy in the future as they seek to repay debt.

### **United States**

In the United States, the financial crisis stimulated substantial debate regarding the governance of global financial markets with the policy makers calling for the creation of a global financial regulator to monitor both domestic financial markets and ensure that other countries implement adequate prudential regulations (Zimmermann 2010). The 2007 financial

crisis which set off as the US housing market collapsed offered no guarantee of US leadership in the creation and modification of suitable global financial standards. In deed, the US regulators faced major challenges in trying to focus on the international economy while its internal economy was falling apart.

The early stages of the crises were therefore characterized by deep cuts in the US federal funds interest rates nationalization of Northern Bank UK, introduction of the term auction facility at the Federal Reserve, the take over of a major investment bank, Bear Stearns, among other measures (Obersteiner 2011). However, some of the interventions put forth only served to prolong the crisis rather than providing a solution to the situation. In December of 2007, the US government introduced the term auction facility which made it easier for banks to borrow from federal reserves (Taylor 2008). The measure was aimed at increasing the flow of credit in the money market through the reduction of interest rates. This saw a substantial reduction of spreads in the money market during the initial periods of its implementation but this trend only lasted for a short period of time. The government's temporary cash infusions implemented under the stimulus Act of 2008 which aimed at sending financial support amounting to over \$ 100 billion to individuals and families in the United States was not successful either. Just like the liquidity facilities, the temporary cash infusions were not focused on dealing with the underlying causes of the financial crisis and since the rebate was financed through borrowing rather than money creation, the policy only served to intensify national debt (Taylor 2008).

The failure of this policy was further intensified by consumer's failure to spend as predicted by the permanent income theory of consumption. Consumer spending remained limited due to widespread uncertainties and the consumption was not jumpstarted according to the policy maker's expectations which consequently increased income rather than consumption. The initial cuts in interest rates in 2008 which saw the federal funds rate target decrease to 2% presented a major challenge to an economy that was already struggling with a credit crunch. Slight reduction in interest rates would perhaps have been effective in rectifying the situation. However, this was only achievable if the interest rates cuts were much less aggressive. The sharp cuts in the federal funds rates led to the depreciation of the dollar which in turn resulted in plummeting of world oil prices evidenced by the doubling of prices from \$ 70 per barrel to \$ 140 in a period of one year (Taylor 2008).

### **United Kingdom**

The United States credit crisis appeared as a foreign concern for United Kingdom in the early 2007 (Tindall 2007).

However, in mid 2007, when BNP Paribas announced that it would be unable to withdraw funds from its hedge funds and Northern Rock requested for emergency financial support from the Bank of England, the effect of the financial crisis became a reality in the region. In response to the crisis, the Prime Minister Gordon Brown, Chancellor of the Exchequer Alistair Darling, and the Bank of England governor Mervin King sought to implement policies which were aimed at managing the global financial crisis that had hit the region's economy. The measures included the nationalization of financial

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institutions and purchase of risky assets (Tindall 2009). The financial regulators in UK ensured that the value added tax was reduced from 17.5% to 15%, the pension for the aged was raised while the government introduced new tax breaks (Tindall 2009). A total of ? 300 billion was injected into the economy in an attempt to salvage the situation while the bank interest rates were slashed to a historic 0.5 in March 2009 after the 50 billion pound rescue package failed to take effect in the preceding months (Obersteiner 2011).

## **Effectiveness of International Regulation in Dealing with the Crisis**

The severity of the global financial crisis revealed major weaknesses in the international architecture for prudential financial regulation that has been constructed since the mid 1970s (Zimmerman 2010). While policy makers responded to the crisis through a flurry of ambitious initiatives to reform international standards and strengthen the international regulatory regimes, the questions remain as to whether the regulation of global finance will safeguard the global economy against such crisis in the future and to what extent the financial regulation system should be changed in response to the crisis. This would only be effective if applied on a global scale since the regulations may impose a greater cost on domestic firms than foreign markets resulting in disequilibrium. It is evident from the severity of the global financial crisis that there are substantial weaknesses in the international financial regulation mechanism.

Consequently, the aftermath of the crisis saw the formulation of numerous reports and regulatory initiatives which were published by national

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regulatory agencies, financial industry associations and international standards setting bodies. The financial stability forum further integrated these initiatives into a unified international coordinated response which was released in 2008 and incorporated over sixty recommendations to the crisis. While the policy presented through the financial stability forums were quickly endorsed by the G7 among other major international bodies, the effectiveness of the recommendations in the long run remained in question. Since the international financial regulation has emerged in response to the power and interest of the world's major economies, most of these policies favoured the sectors where leading states could reap benefits while the areas where they would incur greater costs were narrowed in scope. Consequently, the measures proposed served to benefit the major world economies and continued to economically oppress the developing economies. In the analysis of the 2007 global financial crisis, the lasting power of US and Britain economies global financial regulation should be critically analyzed. This is because the domination of these countries in the global market has adversely affected the global economy due to the fragmented, weak, and exclusive institutional context that has emerged in the recent past.

Indeed, David Singer agrees that the central role played by United States in the global economy requires able leadership and ambitious regulatory regimes in absence of which results in increasingly vague principles and guidelines which puts the future of the economy at risk (Zimmermann 2010). Elliot Posner further observed that the European Union was very eager to use their economic influence to export EU models to the international level

during the crisis (Zimmermann 2010). The fact that the financial crisis hit at a time when the European Union had increased its capacity to influence international regulatory outcomes due to intensified regional integration and its increasing financial market size further raises a lot of concerns regarding the effectiveness of these economies in international financial regulation.

Governments and policy makers should therefore aim at ensuring the shift of power from major economies by diminishing the role of US and British financial markets and major firms in international regulation and putting less emphasis on their financial power which stems from the reputation of New York and London financial centres (Zimmermann 2010). Although the East Asia and other emerging powers are not ready to take on the leadership role in international regulation politics, their active contribution to international regulation seeks to challenge the status quo and are more critical of the existing international standards in banking regulations which may lead to reforms necessary to ensure future stability of the global economy (Zimmermann 2010).

## **Domestic Policies and the Financial Crisis**

Past literature has revealed that when the domestic societal actors are engaged in debates about international financial regulation, the scope is often narrow relative to other economic areas such as trade politics (Zimmermann 2010). This is primarily due to the complexity of issues involved, the consequences, and an institutional context that in most advanced countries gives financial analysts and regulators considerable autonomy from domestic interests and legislative assemblies. Societal actors who take active interests in constructive international financial debates are <https://assignbuster.com/introduction-formulate-measures-that-would-avert-future-crises/>

financial market participants who are directly affected by international regulations. These actors are mostly concerned with adjustment costs of new standards and view international regulation coordination as a means to gain access to a greater market share. Consequently, they often oppose intrusive regulatory measures and support market driven solutions which limits the efficiency of measures presented to solve the financial crisis.

Domestic politics have indeed played a major role in the financial crisis with the large scale use of the tax payers' money to rescue financial institutions being used as a tool for politicizing financial regulations especially in the United States and Britain. Consequently, domestic politics unleashed pressure in favour of stronger regulation policies and increased the involvement of legislative bodies in financial regulation (Zimmermann 2010). Consequently, the severity of the 2007 financial crisis demanded the generation of new kinds of regulations for defensive reasons at a time of weakened political legitimacy and for improvement of industries, confidence restoration, and increasing market share. However, the politicization of financial regulation in Europe had an effect of weakening the association between European Union policy entrepreneurs and multinational financial firms which hindered the effectiveness of such policies in solving the financial crisis.

## **Conclusion and Recommendations**

The global financial crisis of 2007 adversely affected the global economy leading to a recession.

While many causes have been put forth to explain the reasons for its occurrence, the housing bubble and the credit crisis in the US have been cited as the major causes of the crisis. In order to reduce the likelihood of such crisis from occurring in the future, much emphasis has been put on increased international financial regulation. However, the appropriate policy response to the crisis extends beyond tougher international regulations to smarter requirements combined with effective political and financial leadership (IMF 2009). This is because as evidenced in the crisis, the banking sector which is already highly regulated proved vulnerable to the systemic shock which has been attributed to lack of coordination and adequate communication in the sector. Consequently the government and financial regulators should aim at restoring the market disciplines, address the fiscal risks posed by systemic institutions, and restoring the level and quality of bank capital in order to avoid such crisis from occurring in the future (IMF 2009). In addition, the role of international financial regulation should be delegated to both major and developing economies in order to promote efficiency and avoid conflict of interests.

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