Global Financial Crisis and Global Response

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Introduction

The world has undergone the worst economic crisis since the Great Depression of the 1930s. It is not clear exactly which factors instigated the crisis, but there are many candidates; the formation of an asset bubble in the United States (US), and its subsequent crash, continued excessive consumption in the US, irresponsible lending and borrowing, non-recognition of risks in some asset classes, productivity slowdown, debt default, regulatory inaction, and some policy mistakes.

The purpose of this paper is to evaluate the global economic and financial crisis, examine global responses and document lessons.

Part I - A Brief History of Crises

'Those who cannot remember the past are condemned to repeat it'- George Santayana (Spanish Philosopher, essayist, poet and novelist, 1863-1952)

The Great Depression of the 1930s

The world's deepest economic crisis is generally regarded as the Great Depression that dates back to the sudden crash of the US stock market on Black Tuesday, October 29, 1929. This took place in the interlude of the two World Wars, the World War I and II.[2]

After the World War I, the victorious US experienced a boom with its stock market rising rapidly. It had also emerged as the major creditor and financier of post-war Europe. Many European countries had been greatly weakened by the war itself, by war debts, and, by the need to pay war reparations. The USA went into a mild recession in 1928, as a result of the US Federal Reserve raising interest rates to curb excessive speculation in stocks. Six months after this, the stock market crashed, and the US economy spiralled down to the Great Depression. The Depression was precipitated by a series of natural causes, as well as policy mistakes.

The economic impact of the Depression was severe. By late 1932, stock prices in the US had dropped to only about 20 percent of their value in 1929. This ruined thousands of individual investors, and the precipitous decline in the value of assets greatly strained banks and other financial institutions, particularly those holding stocks in their portfolios. By 1933, 11,000 of the 25,000 US banks had failed. Consequently, both the output and employment continued to fall drastically. By 1933, US manufacturing output had fallen to 54 percent of its 1929 level, and unemployment had risen to between 12 and 15 million workers, or 25-30 percent of the work force.(Krugman 2009)

There are many competing theories of how the US recession spiralled down to the Great Depression. One such theory suggested by John Maynard Keynes explains that if aggregate consumption falls due to savings, firms may not wish to expand investment. Firms may feel that future profits will be lower due to expected low consumption. This in turn lowers the employment, and household income, instigating a vicious circle of low consumption, low sales, low investment, high unemployment, and low household income.[3] The policy advice was to supplement the private consumption with government consumption through expansionary fiscal policy.

The monetarist arguments put forward by Milton Friedman and Anna Schwartz suggested that the cause of the Great Depression was the fall of money supply in the US.[4] They claim that the US Federal Reserve (US Central Bank) of contracting the money supply during the Depression, thereby aggravating it. This view was later confirmed by Ben Bernanke, the current Chairman of the US Federal Reserve.[5] This was further confirmed by several economists from the Austrian School who suggested that expansion of money supply in the 1920s generated a credit-driven economic boom, which was not sustainable.[6] The subsequent monetary easing by the could not stop the Depression unfolding.

Some economists, including Ben Bernanke, argue that the adherence to the 'gold standard' (the exchange rate regime where national currency was linked to gold) by the US Federal Reserve during the Depression made it difficult for policy makers to loosen monetary and fiscal policies, in response to the drop in aggregate demand. Later on, as the Depression worsened, they had to abandon the gold standard.[7] The neoclassical argument of the cause of the Great Depression is that countries suffered from dramatic drops in productivity. This led to a drop in output.[8]

The view proposed by Irvin Fisher was that debt deflation caused the Depression. The investment opportunities that existed prior to 1929 led to excessive borrowing by firms. This also led to speculation and the formation of asset bubbles. As the bubble collapsed, the price of debt rose, and the debt could not be liquidated, causing bankruptcies in firms as well as in financial institutions.

The structural weaknesses in banks that existed at the time of the Depression are also viewed as causal factors of the Depression. Rural banks had lent excessively to farming, and urban banks had invested heavily in the stock market and had made risky loans. The drop in farm prices and the over-mortgaged properties made farming community heavily indebted, and defaulting, causing widespread rural bank failures. Urban banks also began to fail due to the poor quality assets and inadequate capital.

The protectionism and retaliatory tariffs imposed by the US in the post WWI era are also blamed for contributing to the Great Depression. As a remedy for generating demand for domestic goods in the post WWI era, the US imposed high tariff walls. This disrupted the flow of international trade and flow of funds from the US to Europe, worsening the international crisis. To stop such protectionist measures, prior to the Great Depression, over 1000 economists presented a petition to the US government, warning of the adverse repercussions of protectionist policies, but the government and its policy makers did not heed to it.

Once the US economy slumped and the flow of US investment credits to Europe dried up, those economies collapsed as well. The depression hit hardest those nations that were most deeply indebted to the US, namely, Germany and Great Britain. In Germany, unemployment rose sharply beginning in late 1929, and by early 1932, it had reached 6 million workers, or 25 percent of the work force. Britain was less severely affected, but its industrial and export sectors remained seriously depressed until World War II. Many other countries had been affected by the slump by 1931.

The depression ended in the 1930s and 1940s for different countries. The recovery is linked to several factors. The 'gold standard' was abandoned by the US, providing greater space for fiscal and monetary policies. The onset of the World War II raised the aggregate demand and mopped up the excess supply of labour. Generous government contracts relating to the needs of the war in the US helped raise the output. Perhaps the business cycle turned upward naturally.

The macroeconomic policy debate is all about active polices versus inaction. Activists (or Keynesians) suggest that the return of the economy to the natural equilibrium takes time, and action is needed to quickly regain the macroeconomic equilibrium. Monetarists (those who propose no action) suggest that the self adjustment in the economy is sufficiently fast, and government action is plagued with implementation delays. Such late action may cause undue effect on the economy.

After the recovery from the Great Depression, policymakers and economists thought that they knew how to avoid economic and financial crises, and how to quickly resolve such crises; pour in money into hands of the private sector through massive fiscal sector projects, relax monetary policy, and supply enough liquidity to all problem banks, or perhaps *do nothing*. The optimism on the ability to tame a depression led many economists to declare that 'central problem of depression prevention has been solved'.[9]

Though this optimism was proven correct by looking at the US experience until it was hit by the 2008 crisis, the world experience shows that many more crises have occurred in various parts of the world after the Great Depression, causing considerable pain.

The Latin American Crises

Latin American countries have been prone to economic crises for generations. Those countries were plagued by currency crises, bank failures, debt default, and hyperinflation. The root cause has been the weak elected governments alternating with military rulers, both trying to buy popular support with populist programs they could not afford.[10]

By the 1980s, Latin America had learned its lessons. The countries privatised state-owned enterprises, restrictions on imports were lifted, budget deficits narrowed, and efforts were made to control inflation and build the confidence of currency. Yet, they could not escape from crises.

Two major economies in Latin America, viz, Mexico and Argentina, progressed rapidly in the 1980s, expanding trade and stabilising exchange rates. Mexico established the North American Free Trade Agreement (NAFTA) with the US and Canada in 1990, and Argentina established a currency board system in 1991. By 1991, both countries had established stability in exchange rates.

However, by 1993, inflation in both countries had risen to very high rates, though the exchange rate stability was maintained. The current account balance also rose to high levels. In Mexico, it rose to 8 per cent. (Krugman 2009).

Irrespective of economic reforms, Mexico did not register a high enough economic growth from 1980 to 1995. In rural parts of Mexico, peasant uprising took place during 1994. In March 1994, the opposition leader was assassinated. During the election time in 1994, money supply surged upsetting the foreign exchange stability.

By December 1994, foreign exchange drained, and Mexico devalued its currency by about half of what economists thought was necessary. The partial devaluation prompted speculative attacks, and Mexico faced a serious currency and economic crisis spilling over to other countries, such as Argentina. Finally, Mexico was bailed out by the US and Argentina by the World Bank. Two years after the crisis, the two countries recovered. The recovery was primarily due to the increased world demand for Mexican and Argentine products boosted by the depreciated currency.

Japanese Crisis

By 1990, Japan had developed a significant asset bubble, manifested mainly in the stock market and the real estate market. To contain the speculative bubble formation, the Bank of Japan increased interest rates. The bubble burst, and stock and land prices fell by about 60 per cent. Initially, the decline was regarded healthy, but the continuing decline could not be contained thereafter. This was primarily due to the willingness of the Japanese public to save rather than consume. Japan fell into a recession with deflation.

Bank of Japan began to stimulate the economy by relaxing monetary policy. Interest rates were dropped to zero, but the economy did not respond.

According to Keynesian economists, Japan was in a 'liquidity trap', and the remedy was to boost consumption through fiscal expansion. However, the fiscal expansion created a new problem for Japan, as the budget drifted from a surplus to a large deficit, without any hope of a recovery.

Japan finally began to recover in 2003 due to the US demand for Japanese consumer goods, and Chinese demand for Japanese intermediate goods, but this was a very fragile recovery.

Crisis in Europe

Europe Ran a Managed Exchange Rate Regime from the 1970s to the 1990s

European countries had formed a joint system for the coordination of monetary and exchange rate policies from 1979 to the early 1990s. This European Monetary System (EMS) consisted of two major components: the creation of an artificial unit of account named the European Currency Unit (ECU) and a fixed exchange rate system known as the ERM (Exchange Rate Mechanism). There were 8 original participants in the ERM: France, Germany, Italy, Belgium, Denmark, Ireland, Luxembourg and the Netherlands. Other countries, Spain (1989), Britain (1990) and Portugal (1992) joined later.

The ERM was essentially a managed float exchange rate system where the currencies of participating countries were allowed to fluctuate within pre-specified bands.

Germany played the central role in the determination of exchange rates among countries. However, after the unification of the East Germany and West Germany in 1990, the unified Germany faced a wide budget deficit, and rising inflation. The German Central Bank had to raise interest rates to alleviate fears of further inflation. This caused capital outflow from both member countries of the ERM as well as non-member countries to Germany. To maintain the exchange rate peg, the member countries had to intervene in the foreign exchange market, thereby making the monetary policy ineffective. This affected the UK, which was already in a recession, most severely. Furthermore, hedge funds and currency speculators began to attack the British Pound, and finally, the UK withdrew from the ERM in 1993.

Sweden, though a non-member, also went through a similar process. It attempted to maintain the managed exchange rate system by raising interest rates all the way up to 500 per cent. Finally, it also abandoned the managed floating exchange rate system in 1992.

Both countries recovered after they allowed the exchange rate to freely float.

East Asian Crisis

The East Asian crisis began with Thailand running a grossly misaligned exchange rate regime. Thailand experienced a rapid economic growth in the 1980s and 1990s. Much of its growth was due to the open economic regime that attracted foreign capital, by way of direct investment and portfolio investment. In addition to investment inflows, both private enterprises and the government had also been borrowing foreign funds. Inflows of such funds increased the foreign reserves of Thai central bank, and expanded the Thai domestic money supply. Thai central bank could not control the domestic monetary and credit expansion, without letting the Thai Baht appreciate. Such investments and economic boom led to a surge in imports, and at the same time severe international competition eroded Thai export performance. The current account deficit was met through further capital inflows. Some of those capital flows were invested in real estate assets, and some were purely speculative investments.

As the current account deficit worsened, speculators had doubts about the Thai central bank's ability to maintain the fixed exchange rate regime. Foreign lenders were not eager to lend money to Thailand. Speculators began to attack the Thai Bhat precipitating a currency crisis since the Thai central bank could not support its currency any longer. Thai economy crashed, together with many other similarly positioned economies such as Indonesia, the Philippines, South Korea and Malaysia. The crisis gave some pain even to strong economies, such as Hong Kong and Singapore.

Subsequently, Thailand, and many other countries, had to be bailed out by the International Monetary Fund (IMF), and those countries went through a difficult time for a few years. Their recovery was due to increased export demand arising due to the depreciated currency.

Part 2 - Nature, Build-up and Magnitude of the 2008 Crisis

'The crisis is attributable to: inappropriate macroeconomic policies, prolonged low savings and high consumption, blind pursuit of profits by financial institutions, lack of self-discipline among rating agencies, mismatch between financial innovation and financial supervision' (Wen Jiabao, Prime Minister of China)

The epicentre of 2008 crisis was the US. But, the US under Alan Greenspan (Chairman of US Federal Reserve Board) enjoyed reasonably good economic growth and price stability for over two decades. The US Congress commended him in 2005 that he guided the monetary policy though stock-market crashes, wars, terrorist attacks, and natural disasters, and made a great contribution to the prosperity of the US. However, almost three years later, Greenspan was blamed for the current crisis. Krugman (2009) states that 'Greenspan's story is also the story of how the makers of economic policy convinced themselves that they had everything under control, only to learn, to their horror-and the country's pain-that they didn't'.[11]

During the Greenspan era, inflation remained low, and the recessions were short lived. Stock market showed a 10 per cent rise each year, which Greenspan saw as 'irrational exuberance' (actions by people lending to an asset price bubble). The critics argue that though Greenspan warned against the 'irrational exuberance' but never did anything to contain it.

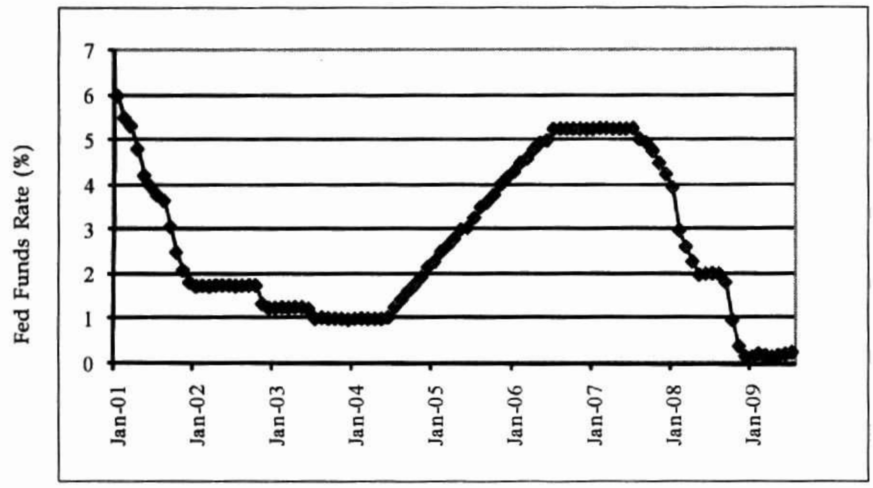

Figure 1: Fed Funds Rate 2001- 2009

Source: Federal Reserve Board, USA.

Unlike the action by a previous Fed Chairman, William McChesney Jr., who declared to 'take away the punch bowl just as the party gets going', the formation of asset bubbles were tolerated, without raising interest rates. This tolerance of market optimism served the US economy well in creating jobs, and generating a perception of wealth that led to excessive consumption.

Benefitting from US consumer demand, the world economy was expanding rapidly. However, there has not been a significant productivity improvement, or innovation, since the advent of the Internet, and the subsequent collapse of the dot.com bubble.

US Federal Reserve under Mr. Greenspan maintained a low interest rate regime where Fed Funds rate was lowered to about 1 per cent (Figure 1) after the dot com bubble burst, for about 3 years until 2005.

The low interest rate regime generated substantial liquidity in the banking system, as well as a higher demand for bank loans, especially for financing highly inflated home mortgages. Lending for home mortgages were not so risky for banks which only acted as loan originators, since those mortgages were bundled as structured assets (securitisation) and sold via housing finance institutions to investors. The low of risk of mortgage lending encouraged banks to lend to those households who could not even pay a down payment for their mortgages (sub-prime borrowers).

Some households who became wealthy with the rise of the stock market, attempted to benefit further from ever increasing housing prices by buying more and more houses with borrowed money.

Thus, the US financial sector misallocated resources to real estate, financed through the issuance of exotic new financial instruments. A significant portion of these instruments found their way, directly or indirectly, into commercial and investment bank balance sheets. Banks and non-bank financial institutions in the US were further encouraged to lend by the financial deregulation.

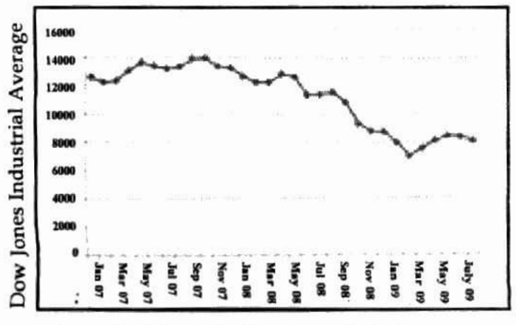

Figure 2 : Fall of US Stock Market

(Dow Jones Industrial Average)

Source: Yahoo Finance

With the fears of future inflation, the Federal Reserve Board began to gradually raise interest rates, beginning 2005 to a maximum of 5.25 per cent in July 2006 and was maintained at this high level till about July 2007. Many sub-prime borrowers have had floating rate mortgages, which became expensive with the high interest rate regime, and they began to default on their mortgages.

Financial system saw several fears being realised. Defaults on mortgages rendered enhanced the risk of structured assets, and in many cases their value dropped. The risk and the price of the structured assets were not revealed clearly, and with the subsequent defaulting on repayment of housing loans and the collapse of the housing market, the value of those assets disappeared (they became toxic assets). As a result, liquidity dried up in many major financial institutions.

The first victim of the crisis was a major bank in the UK. Northern Rock sought and received liquidity support from the UK government in September 2007. In February 2008, Northern Rock was nationalised. On September 7, 2008, US government nationalised (placing into conservatorship) the two US home mortgage lenders, Fannie Mae and Freddie Mac. On September 14, 2008 US investment bank, Lehman Brothers filed for bankruptcy. According to some analysts, that day marks the beginning of the global financial crisis.

Since then, a large number of financial institutions have merged or collapsed. Major markets have collapsed, reducing the wealth of nations (Figure 2). Aggregate demand has fallen, raising inventories and bankrupting

Fiscal deficits, developed markets

% of GDP; J.P.Morgan fsct 2008 and 2009 boxed

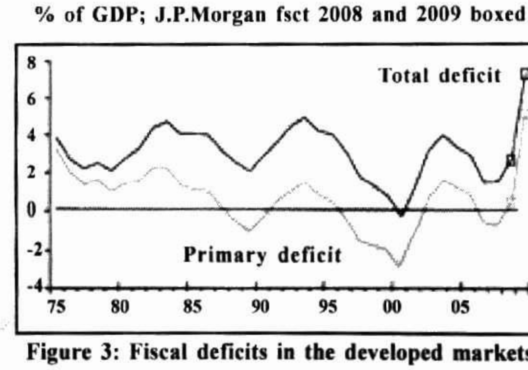

Figure 3: Fiscal deficits in the developed markets

Table 1 : Global Economic Projections by the IMF

1a - Advanced Economies

	2007	2008	2009	2010
World Output	5.1	3.1	-1.4	2.5
Advanced Economies	2.7	0.8	-3.8	0.6
United States	2.0	1.1	-2.6	0.8
Euro Area	2.7	0.8	-4.8	-0.3
Germany	2.5	1.3	-6.2	-0.6
France	2.3	0.3	-3.0	0.4
Japan	2.3	-0.7	-6.0	1.7
United Kingdom	2.6	0.7	-4.2	0.2
Canada	2.5	0.4	-2.3	1.6
Other advanced economies	4.7	1.6	-3.9	1.0
Newly industrialised Asian economies	5.7	1.5	-5.2	1.4

Source : IMF, World Economic Outlook updated, July 2009.

1b - Emerging and Developing Economies

	2007	2008	2009	2010
Emerging and developing economies	8.3	6.0	1.5	4.7
Africa	6.2	5.2	1.8	4.1
Central and Eastern Europe	5.4	3.0	-5.0	1.0
Commonwealth of Independent States	8.6	5.5	-5.8	2.0
Russia	8.1	5.6	-6.5	1.5
Developing Asia	10.6	7.6	5.5	7.0
China	13.0	9.0	7.5	8.5
India	9.4	7.3	5.4	6.5
ASEAN-5	6.3	4.8	-0.3	3.7
Middle East	6.3	5.2	2.0	3.7
Western Hemisphere	5.7	4.2	-2.6	2.3
Brazil	5.7	5.1	-1.3	2.5
Mexico	3.3	1.3	-7.3	3.0

Source : IMF, World Economic Outlook updated, July 2009.

Table 2: Net Impact on the deficit of fical stimulus package ($bn)

Fiscal Year	Direct Spending	Tax and Transfers	Net increase in the deficit
2009	29	141	170
2010	116	240	356
2011	106	69	174
2012	54	-5	49
2013	27	-1	25
2014	13	11	24
2015	7	4	11
2016	3	-3	0
2017	2	0	1
2018	1	2	3
2019	0	3	3
2009-2019	356	460	816

Source: Congressional Budget Office, USA.

many firms. Unemployment has surged.

One by one, financial institutions and major manufacturers of consumer goods in the US collapsed while unemployment surged. Countries that depended on US consumer demand for their exports also began to collapse. The crisis has lowered global economic growth. World economic growth in 2009 is projected to be mere 0.5 per cent, advanced economies shrinking at 2 per cent and developing and emerging economies growing at 3.3 per cent (Table 1).

According to the IMF, 'the psychology that lies behind these forecasts is even more disturbing. Around the world, confidence is faltering. Investors have lost confidence in many companies, and especially banks, because they fear that there are further losses to be realised. Consumers are holding back from buying cars and from other big discretionary purchases, because they fear for their jobs'.[12]

Part 3 - Global Fiscal Policy Response

'In the long-run everyone is dead' (John Maynard Keynes)

On the onset of a massive loss in employment and collapse of many financial and non-financial firms, governments have to be seen to take action. Many international institutions, usually critics of heavy government expenditure have urged governments to engage in fiscal stimulus, cautiously. Governments have resorted to Keynesian policies of active engagement. This will raise the budget deficit to historically high levels (Figure 3).

The most notable fiscal package is the US package of nearly a trillion US dollars. It will be spent over a period of 10 years as shown in Table 2, via direct spending (infrastructure, capital investments in education, health, green energy, etc.) or tax breaks and transfers (unemployment benefits, tax breaks, etc.).

The heavy expenditure will have future problems for the governments. The resulting debt overhang will continue to cause instability and inflation.

Part 4 - Global Monetary Policy Response

'Credit is the life blood of the economy' -(Barak Obama- President of the US)

Central banks around the world began repairing their financial system, which is the major channel of the monetary transmission mechanism. They are relaxing monetary policy, (lowering interest rates almost to zero), despite the risk of falling into a Japan style liquidity trap. The major effort has been to get financial institutions to supply credit and consumers to demand credit.

In many countries with independent monetary policies, exchange rates have been fluctuating widely. This has not affected the stability of those countries, though some countries lost foreign exchange reserves by attempting to stabilise nominal exchange rates.

The aim of monetary easing is to restore the public confidence in the financial system as well as boosting the aggregate demand.

Part 5 - Global Regulatory Response

'Before the crisis, there was almost no international policy coordination. And during the crisis, the initial policy response was far from collaborative, let alone coordinated. For example, countries rushed to protect their own banks with guarantees, at the risk of causing runs in less protected systems in neighboring countries, while liquidity provision has been mostly directed at domestic financial institutions' (Dominique Strauss-Kahn, Managing Director of the International Monetary Fund)

Regulators never seem to get it right. After a crisis, they bring in regulations to avoid a similar crisis from happening, only to see that while they are fine tuning the new regulation, a brand new crisis happens. This is illustrated in the stories of Basel I and II.

Supervision and regulation became an internationally coordinated activity in view of the internationalization of banking business and the intense competition for financial services. To facilitate this international coordination, the Basel Committee on Bank Supervision (BCBS), Switzerland, was formed in the aftermath of the failure of a German bank (Bank Herstatt) in 1974.[13] The Committee's Secretariat is provided by the Bank for International Settlements (BIS) in Basel.

First, it was Basel I, a simple accord that established a minimum capital requirement or capital/asset ratio for banks, and a simple way of ascertaining the value of assets. This accord was established in 1988 by the BCBS.

Basel I has been progressively being introduced in G-10 countries since 1988, and was fully adopted by law in 1992.[14] Many other countries have been adopting Basel I since 1988.[15] However, a major criticism of banks in adopting Basel I was the manipulation of risks associated with bank assets. For example, banks converted the mortgages into supposedly less risky assets by selling the mortgages to housing finance institutions in exchange for Mortgage Backed Securities (MBS), a structured financial product, a prime cause of the current crisis.

Moreover, Basel I could not effectively contain a massive banking crisis in East Asia in 1997, and other similar crises.

In the aftermath of the Asian financial crisis, the central bankers and finance ministers of G-10 countries began devising a set of improved banking regulations at the BCBS with the hope of reducing the harm from future financial crises.

The task was complicated since banks needed space to perform, and to undertake risks, while regulators wished to ensure safety of the banks. The regulators finally came out with a new accord, Basel II in 2004, which they thought would avert another major financial crisis.

Basel II has several added layers to ensure that banks bring enough capital to cover the risk of assets. It addresses credit risk of bank assets similar to Basel I, but adds on two more risk components, operational risk and market risk of bank assets (Pillar 1).

Furthermore, bank regulators and supervisors could modify the riskiness of assets using their views on other types of risks such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk (Pillar 2). To discourage banks undertaking unnecessary risks, Basel II requires banks to disclose information to the market, so that stake holders could have a better view of risks faced by the bank (Pillar 3).

Even before the occurrence of the current crisis, Basel II capital accord came under criticism. Major criticisms were centered on notions such as procyclicality, inconsistency of regulatory review, arbitrage out of banking sector to show a lower risk, country variations, rating shopping, and treatment of operational risk.

At the onset of the crises, the immediate response of the regulators was to relax regulation. After, resolution of the current crisis, international regulators, no doubt, will introduce Basel III, and will fine tune it until the world is hit by a brand new crisis.

In resolving the crises, the IMF suggests that the task for governments is to push the bank restructuring process forward—with an emphasis on cleansing balance sheets—using its authority to:

- Re-examine bank balance sheets on a worst-case basis, determine the viability of various institutions, and restructure them if required. Authorities need to be ready to respond as needed, including fully-fledged intervention.
- Provide public support, where necessary, to banks that can be rehabilitated, in the form of capital, bad asset carve outs, and guarantees.
- Sell or wind-up insolvent banks quickly, depending on whether any franchise value remains.
- Establish new public resolution agencies to manage "bad assets" to maturity or sale. On this last point, the United States and Western Europe can learn from the previous experience of countries like Korea, Malaysia, Thailand, and also Sweden, which set up such agencies, and often recovered a lot of public money.

Part 6 - Protectionism and Openness

'We must not revert to isolationism and unrestrained economic egotism. The leaders of the world's largest economies agreed during the November 2008 G20 summit not to create barriers hindering global trade and capital flows. Russia shares these principles. ... Excessive intervention in economic activity and blind faith in the state's omnipotence is another possible mistake' – (Vladimir Putin, Prime Minister of Russia)
'It would be a mistake to *send the message that we are just looking after ourselves' – (Barak Obama, President of the US)*

Government efforts aimed at resolving the crisis of 2008, contains some components that pose greater threats to the recovery from the crisis. Those are the measures of 'trade protectionism' and 'financial protectionism'. A notable feature in the US rescue package is the 'Buy American' clause, where consumers are urged to spend locally.

Such protectionism, as was repeatedly proven, will distort the global resources allocation, and lower global output.

Trade protectionism is raising tariff barriers to discourage imports. Financial protectionism is the conditionality on financial institutions being rescued that they should channel credit to domestic industries. This, as the President of the European Central Bank (ECB) stated, will lead to a deeper global economic slump.

Trade and financial protectionism could hurt both developed and developing countries. For example, Sri Lanka's exports of goods and services (especially migrant workers) generate funds to purchase essential goods such as oil and pharmaceuticals. Closing up of goods, capital and labour markets in developed countries will lower foreign inflows substantially, causing a distress to Sri Lanka.

Many world leaders as well as leaders of multilateral institutions are against the protectionism proposed by short-sighted domestic politicians and industrialists, and hopefully may be able to avoid a catastrophic decline of the wealth of all nations arising from such protectionism.

Part 7 - Lessons from the Crisis

It is important to *learn* new lessons from the crisis, and its resolution, and not to *unlearn* good lessons learnt during tranquil times. The first such lesson is that market mechanism is always the first best option. Though some developed countries 'nationalised' financial institutions, it should be for a brief period of time.

If not, moral hazard problems associated with the government ownership of assets will plague those institutions. The nationalisation was launched merely to lower the risk perception of banking assets. Thus, it should be reversed as soon as the crisis is resolved.

It is also important for those who run institutions to clearly recognise risks associated with the operations of those institutions. It is doubtful that the many of the members of the Board of directors of failed institutions recognised the risks of their assets. It is also doubtful if regulators could fully comprehend those risks.

Lack of such knowledge leads to a principal-agent problem, where some employees of institutions gain short-term benefits by accumulating risky assets, while endangering the viability of institutions.[16] Such risks are not either revealed or understood those who have the responsibility of the long-term survival of the institution.

At country level, policy consistency, especially the consistency in monetary, fiscal and exchange rate policies, needs to be maintained at all times to avoid catastrophic crisis.

Part 8 - Recovery

The recovery from the Great Depression of the 1930s was linked to expansionary fiscal policy and the exogenous event of the World War II, the two factors that raised the aggregate demand. Monetarists argue that the economy returned back to normalcy through the natural principles of a market economy.

Many crises that took place in countries were resolved through the high export demand from the rest of the world. The current global financial crisis may be overcome by adopting massive domestic spending programs. However, there must not be an exogenous shock in the magnitude of World War.

Perhaps, the recovery will be natural, through market forces, proving that monetarists may be correct. The recovery process could be further facilitated by creating incentives for the human resources development, innovation and productivity improvement, which are the true forces of economic growth.

According to the July 2009 projections of the IMF, the global economy is beginning to pull out of the recession, but stabilisation is uneven and the recovery is expected to be sluggish.

Economic growth during 2009-10 is now projected to be about ½ percentage points higher than the early forecast by the IMF in April, reaching 2.5 percent in 2010. Among the major economies, growth rates have been marked up mainly for the United States and Japan.

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Footnotes:

[1] *The author is attached to the Central Bank of Sri Lanka. Views expressed in this paper are those of the author, and do not necessary represent the views of the Central Bank of Sri Lanka.*

[2] *The World War I (WWI) was fought mainly in Europe between 1914 and1918 involving about 70 million soldiers. The war was ignited with the assassination of the heir to*

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Austro-Hungarian throne by a Bosnian-Serb student in Sarajevo. The two major parties involved in the war were the Entente Powers (France, United Kingdom, Russia, Japan, Italy and the US), and Central Powers (Germany, Austria-Hungary, Ottoman Empire, and Bulgaria). The World War II (WWII) spanned from 1939 to 1945 involving about 100 million personnel. The two forces were the Axis (mainly Germany, Italy and Japan) and Allies (mainly Britain, Russia and the USA). The ignition of the war was the German invasion of Poland in September 1939.

[3] *Keynes (1936)*

[4] *Friedman, Milton and Anna Jacobson Schwartz (1963)*

[5] *In 2002, Ben Bernanke made this startling admission in a speech given in honour of Friedman's 90th birthday: "I would like to say to Milton and Anna: Regarding the Great Depression, you're right. We did it. We're very sorry."*

[6] *Rothbard (1963)*

[7] *Bernanke (2000)*

[8] *Kehoe and Prescott (2007)*

[9] *Quotation by another eminent economist highlighted in Krugman (2009).*

[10] *Krugman (2009)*

[11] *Krugman (2009) page 140*

[12] *Speech By Dominique Strauss-Khan, Managing Director of the International Monetary Fund, at the 44th SEACEN Governors' Conference, Kuala Lumpur, Malaysia, February 7, 2009.*

[13] *On 26 June 1974, a number of banks had released Deutsche Mark (German Mark) to the Bank Herstatt in exchange for dollar payments deliverable in New York. On account of differences in the time zones, there was a lag in the dollar payment to the counter-party banks, and during this gap, and before the dollar payments could be effected in New York, the Bank Herstatt was liquidated by German regulators.*

[14] *The G-10, currently comprises 13 countries, namely, Belgium, Canada, France, Germany, Italy, Japan, Luxemburg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States of America.*

[15] *Sri Lanka adopted Basel I in 1993.*

[16] *Corden (2009)* ■