
Financial Crises and their Lessons

Introduction

Financial crises are not new to the world. According to available literature, financial crises in the world date back to the 1819s when there was a major financial crisis in the United States of America (USA) (Wikipedia, 2011).

The causes of the financial crises were different. In the 19th and early 20th centuries, many financial crises were associated with bank runs, systematic banking crises and banking panics while many recessions coincided with these panics (Wikipedia, 2011). Financial crises can be banking crises, international financial crises and wider economic crises (i.e., recessions and depressions). A situation where a commercial bank suffers a sudden rush of withdrawals by depositors is called a bank run. In such situations, banks cannot immediately fulfil the entire demand for money by the general public, because the bank may have invested its money in a variety of assets, gains of which may realise during a long period of time. This may lead to a bank panic or banking crisis. Examples of bank runs can be seen in the USA during 1931. An international financial crisis may occur when a country is suddenly forced to devalue its currency because of a speculative attack. This may be referred to as a currency crisis or a balance of payment crisis. Likewise, when a country fails to pay back its sovereign debt, it is referred to as a sovereign default. A balance of payment crisis along with a sovereign default can lead to a sudden stop in capital inflows or a sudden increase in capital flight. During 1992 - 1993, some countries in Europe faced with a similar type of international financial crisis.

Further, there were international financial crises in many Latin American countries, when they defaulted their debt in the early 1980s. A wider economic crisis may consist of a recession or a depression. A slow down in growth for a continuous period is usually called a recession. A prolonged recession may be referred to as a depression. The great depression in the 1930s is such an example for a depression. Similarly, the recent sub-prime mortgage crisis and the real estate bubble experienced around the world starting in 2008 led to a recession in the USA and in a number of other countries.

Causes of Financial Crises

The causes of financial crises vary depending on the nature of the crisis. Sometimes, recognition of only one cause for the crisis may be difficult, and a crisis may take place as a result of many causes. These causes may be due to macroeconomic circumstances, microeconomic policies or other reasons. Most of the time, adverse macroeconomic developments are blamed for financial crises. The trigger of financial crisis may be due to errors in macroeconomic policies adopted by relevant authorities. High interest rates, shift of exchange rate regimes and unnecessary slow down or sharp increases in inflation are some of the macroeconomic reasons that trigger a crisis. Although high interest rates may attract more short-term capital, they may create difficulties for financial institutions and governments. When countries are unable to maintain exchange rates, they automatically try to shift into different rate regimes, thus causing imbalances in the external sector. Examples for these can be seen

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during the Mexican Crisis from 1995 to 1997 and the South-East Asian Crisis from 1997 to 1998.

Prolonged deficits in the current account may lead to unstable macroeconomic conditions creating a financial crisis. The countries which have deficits will have problems in financing their budgets, mobilising savings and debt management. Likewise, the Mexican Crisis had a route of deficit in the current account, while the South-East Asian Crisis was created due to capital flight. Shifting of exchange rate regimes and high short-term borrowing created instability in these countries and ultimately led to capital flight, causing a financial crisis.

Unfavourable microeconomic policies can also cause financial crises. The Ireland's financial crisis occurred due to a property lending boom. Similarly, in most countries, weaknesses in the supervisory role of financial institutions either due to insufficient legal framework or weaknesses in supervision may lead to a failure of financial institutions. Lack of transparency in providing information to supervisory authorities sometimes leads to a collapse of financial institutions. Mismanagement of financial institutions is a common cause for failure of financial institutions in emerging markets. Examples for these types of financial crises can be found in Sri Lanka where several financial companies failed during 1988 - 1989.

Mismanagement of credit given to financial institutions may create credit bubbles, and bursting of which, may lead to failure of financial institutions. The credit crunch in the USA during 2007-2009 was one of the reasons for the recent financial crisis where US financial institutions failed as a result of their inability to repay loans. Sudden withdrawals of bank credit develop difficult situations for the borrowers to repay the credit.

Government directions sometimes due to political reasons can pave way for a financial crisis. For instance, sub-prime mortgage crisis in the USA was created partly as a result of over-supply of construction industry which was encouraged by government directions. The assassination of political leaders in Mexico created financial sector chaos and resulted in a withdrawal of short-term foreign finance which led to a financial crisis.

Financial products, if managed properly, would help develop financial markets. However, development of sophisticated financial derivatives beyond the safety levels may lead to a collapse in these financial markets. One good example for this type of crises is the recent US financial crisis which had a link to sophisticated and unmanageable derivative products.

Undue developments in the debt market, particularly in the government debt, are one of the common causes of financial crises which have common examples from most countries. During 2010-2011, failures in Greece, Ireland and in several European countries occurred due to excessive levels of public debt.

The foregoing explanation supports the fact that financial crises may occur due to one or a series of causes. At the initial stage, one of the several causes would adversely affect one sector such as commercial banking, which would

impact other sectors creating worse situations. Similarly, a crisis occurred in one country may result in crises in other countries. For instance, the South-East Asian countries' financial crisis initially started in Thailand and spread to other countries subsequently. Therefore, a contagion effect is also a cause of a financial crisis. The US crisis in 2008 affected most of the other countries in the world. Therefore, depending on the severity of the crisis in one country, there would be global effects.

US Sub-Prime Mortgage Crisis from 2007

The US sub-prime mortgage crisis was one of the worst-hit financial crises. The crisis began with the bursting of the United State's housing bubble and high default rates on "sub-prime" and adjustable rate mortgages which approximately began in 2005/06. Sub-prime lending is the practice of making loans to borrowers who do not qualify for market interest rates owing to various risk factors, such as income level, size of the down payment made, credit history, and employment status. In the USA, borrowers are rated either as "prime" or as "sub-prime". The prime borrowers have a good credit rating based on their track records while sub-prime borrowers have track records in repaying loans below par. Loans given to sub-prime borrowers are categorised as sub-prime loans. Typically, it is the poor and the young who form the bulk of sub-prime borrowers.

Roughly, five years leading up to 2007, many banks started giving loans to sub-prime borrowers. They did so, because, they believed that the real estate boom would allow people to repay the loans they were taking to buy or build homes. Government also encouraged lenders to lend to sub-prime borrowers. With stock market booming and the system flushing with liquidity, many big fund investors saw sub-prime loan portfolios as alternative investment

opportunities. Hence, they bought such portfolios from the original lenders. Thus the sub-prime loan market became attractive.

One major contributory factor for this crisis was the boom in the supply of housing, which resulted in falling prices and an increase in the default rate of sub-prime borrowers, many of whom were no longer able to repay their loans. Another factor was the problems in collateral for buying houses in the USA. This took place with increased supply of houses for sale while there was a low demand which resulted in decline in house prices. This was coincided with the slowdown in the US economy which made matters worse.

Since the risk of default on such loans was higher, the interest rates charged on sub-prime loans were also higher than the interest on prime loans. However, the repayment capacity of sub-prime borrowers was doubtful. Further, lenders devised new sophisticated instruments, such as derivative products, to reach more sub-prime borrowers. Sometimes, these instruments included payments from the borrowers on different mechanisms, such as the repayment of the principal portion which was to start later. The links of complex derivative products on the loan portfolios were very complicated. Therefore, there were more doubts about the ultimate repayers.

Not only the reckless lenders, but also big institutions such as, Freddie Mac and Fannie Mae, which owned or guaranteed more than half of the outstanding in home mortgage in the USA were widely thought as being more prudent than many others in their lending practices. Ultimately, they too suffered from billions of losses. Not limiting to these financial institutions in the USA, the crisis affected institutions such as Citigroup and Merrill Lynch which are global banks and brokerages to write-off billions of sub-prime losses. Furthermore, despite

efforts by the US Federal Reserve to offer some financial assistance, the crisis led to the collapse of Bear Stearns, one of the world's largest investment banks and securities-trading firms. The crisis also extended to Lehman Brothers and American Insurance Group.

This crisis affected, not only these American institutions, but also many banks in other parts of the world. Since the USA was the biggest borrower in the world, most countries which held their foreign exchange reserves in dollars and invested in the US Securities were badly affected. Countries like Japan, China and India which had invested in the USA had direct adverse impacts from this crisis. Also the global equity markets were badly hit from it. Other than these, countries which had trading links with the USA were affected due to the down-turn in the USA. Therefore, effects of the US crisis were, not only limited the US economy, but also to the global economy.

Consequences of the US Crisis

As a result of the mortgage crisis, lenders in the USA were unable to recover their credits. A number of financial institutions collapsed, and businesses of many non-financial institutions, such as car producers, garment sellers and food sellers faced difficulties in selling their products. Consumer prices in Advanced Economies as identified by the International Monetary Fund (IMF) grew only by 0.1 per cent in 2009. Mortgage giants such as, Fannie Mae and Freddie Mac were affected extensively. The fourth largest investment bank in the USA, the Lehman Brothers, Wall Street's fifth largest bank Bear Stearns, which was acquired by another organisation, and Merrill Lynch collapsed. A number of financial institutions were declared bankrupt, merged, acquired by other organisations, bailed out by the governments or nationalised. An Insurance major, American Insurance Group, was also under severe pressure and collapsed. Not

only in the USA, but also in other countries of the Euro Banking Sector, a number of financial institutions as well as producing firms collapsed due to the US crisis. For instance, Northern Rock and European banking and insurance giant Fortis were partly nationalised to ensure their survival. The General Motors, which is a car-producing firm in the USA, and Mark & Spence were faced with a decline in their sales.

Rating Agencies downgraded their investment ratings of a number of financial institutions. Unemployment surged and growth of employment became negative in several countries. Unemployment in Advanced Economies (as classified by IMF) increased by 8 per cent in 2009. The Chief Executive Officers of several banks (Citi Group and Merrill Lynch) stepped down.

The World Bank and the IMF predicted a slow rate of economic growth in the richest nations and the globe. Current Account balances in a number of advanced countries became negative. Countries suffered with lack of demand for their goods and services and fell into recession. Prices of houses and other goods and services fell. The stock markets suffered with fallen markets. The US recession was officially declared by the National Bureau of Economic Research; a leading panel including economists from major academic institutions. The figures indicated that more US workers lost their jobs in 2008 than any year since the World War II.

Not only the US and European economies suffered, but also other countries such as China, Japan and India faced their biggest ever declines in exports. This was common even to other exporting countries in Asia and Africa. The IMF warned that the world economic growth was to fall to just 0.5 per cent in 2009. Data showed that world output in 2009 dropped by 0.6

per cent. The International Labour Organisation said that as many as fifty one million jobs worldwide could be lost in 2009 because of the global economic crisis.

In order to respond to the crisis, policymakers, including Federal Reserve Bank and the US government, took comprehensive measures to overcome the adverse effect which arose from the financial crisis. Because of the contagion effect of the US financial crisis, many other central banks around the world too took actions to correct the situations in their countries. Among the policy actions, there were monetary policy measures, amendments to legislation, government bail outs and other joint actions implemented. Under the monetary policy measures, reduction of the interest rates and providing liquidity assistance to the affected financial institutions were some of the policy measures implemented by countries. Likewise, new legislations were introduced under regulatory amendments. Legislations relating to lending practices, bankruptcy protection, tax policies, housing, credit counsellors, education and licensing of lenders were drafted or amended by affected countries. Governments came out with financial facilities and proposals for acquisition of financial institutions. Larger financial institutions such as Freddie Mac and Fannie Mae were taken over by the Federal Reserve Bank and several other financial institutions acquired some of the failed financial institutions. A number of larger financial institutions were acquired or amalgamated by other institutions in the USA, the UK (United Kingdom) and many other European countries. Also the US government started purchasing of large amounts of illiquid mortgage-backed securities from financial institutions. Several governments initiated actions to get the approval from their national legislatures to extend bail out amounting to billions of dollars as a measure to

the crisis. Banks increased the amount of loans to small- and medium-sized enterprises. A number of regulatory measures for accounting standards were also proposed by many countries. In addition to these governmental efforts, the Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan, the Bank of Canada, the Swiss National Bank and the Swedish Riksbank announced measures to release liquidity to financial institutions. The IMF provided financial assistance for some countries.

Financial Crises in Sri Lanka

So far, Sri Lanka has not faced a severe crisis. However, the country has faced some difficult economic situations, particularly in the financial sector. A banking crisis occurred in Sri Lanka during the 1880s when the coffee plantations, one of the major sectors that contributed to national economy, were faced with a disease called coffee blight. Several banks which had extended their services to the plantation sector collapsed due to this, and the then government was compelled to intervene and bail out some affected banks during that time (Karunatilake, 1986). Other than this crisis, no noticeable financial crises have taken place in the history of Sri Lanka.

In the recent past, after the political independence in 1948, several financial companies in the country collapsed during 1988 and 1989. The Central bank of Sri Lanka responded to this crisis by extending financial support for distressed financial companies (Central Bank of Sri Lanka, 1988 and 1989). Some of the collapsed financial companies were closed and some were rehabilitated, however, this crisis was not wide spread.

During 1993-1996 government recapitalised State banks, i.e., the Bank of Ceylon, the People's Bank and the National Savings Bank to strengthen the capital base of

these institutions. However, this cannot be considered as a crisis situation, but as a step taken by the government to strengthen government banks.

In addition to these situations, in several occasions, the country faced with some hardships in regard to country's balance of payments and fiscal management. To set the economy on the right path, the government and the Central Bank of Sri Lanka obtained financial assistance several times under the standby arrangement facility of the IMF. Since 1965, the first year that the country received IMF funds under this arrangement, there were seven other instances up to date that the government has sought financial assistance from the IMF to overcome difficult situations in Sri Lanka.

Sri Lanka's financial system stability was not affected due to the US financial crisis. However, the country required to correct its reserve situation which was affected due to external developments. In the latter part of 2009 and 2010, the country was able to recover from the adverse situation which was experienced during the latter part of 2008 and the beginning of 2009. The terrible experience faced by the western world due to the US financial crisis was not experienced by Sri Lanka. The robust legal background available in Sri Lanka, closure of external capital account and corrective measures implemented in regard to financial institutions, particularly in the area of supervision of financial institutions, were some of the reasons that helped evade adverse impacts from the US financial crisis. However, with the intensification of the crisis that was spilled into the real sector of the economy, the effect of the US crisis was felt strongly by the external sector of the Sri Lankan economy.

As a result of the financial crisis, many investors who had intervened in short-term investments

repatriated their investments back to their home countries to meet rising liquidity requirements. The foreign funds which were invested in debt instruments such as Treasury Bills and Long-Term Bonds in Sri Lanka were withdrawn from the country as a result of the global financial crisis.

Due to the slowdown in crisis-driven countries, the demand for Sri Lanka's exports, particularly apparel products, declined substantially. This was a combined effect of reduction in global demand for textile exports and high competitive nature of the export market. Similarly, there was a decline in Sri Lanka's export products such as tea and rubber. Also the growth of the industrial sector decelerated in 2008 compared to 2007. Meanwhile, some local industries resorted to short-term layoff of workers as a result of decline in demand for their export products. The growth of services sector also declined and adversely affected the tourism sector in which tourist arrivals dropped due to the global crisis.

The decline in export earnings and withdrawal of short-term investment by the foreigners, resulted in the balance of payment problems in Sri Lanka. The high growth of imports and lower growth of exports too contributed to a substantial expansion in the trade deficit in 2008 and built up pressure on the exchange rates. The Central Bank of Sri Lanka responded by selling its foreign reserves to prevent exchange rate from devaluation.

The impact of the global crisis through the channels as explained above ultimately resulted in a slow rate of economic growth in Sri Lanka. The impact of the crisis on the economic growth was severely felt during the last quarter of 2008 and the first half of 2009. The lowest economic growth in the first quarter in 2009 which was 1.6% indicated the adverse effects of global crisis on the Sri Lankan economy.

The financial system of the country was robust and was not directly affected by the crisis. No banks collapsed in Sri Lanka. Although some financial companies faced some difficulties during 2008, there was no threat to financial stability in the country. The country was able to maintain price stability too. The inflation declined to sharply to 4.8 per cent by the end of 2009 (Central Bank of Sri Lanka, 2009).

Lessons from the Financial Crises

As described above, financial crises are not new to the world, but they have occurred throughout history. These financial crises have taught many lessons to regulators, governments, financial institutions and to the general public at large. In spite of many lessons learnt from the historical financial crises, financial crises have occurred repeatedly. The lessons learnt may be of macro or micro importance. Some argue that to avoid financial crises, solutions should be tried. Conversely, Alan Greenspan, the US Federal Reserve's previous chairman, suggests that no one should try any action and says that things went well over the long period of deregulation and light-touched oversight, while arguing that the global financial system is now "unredeemably opaque" that policymakers and legislators cannot hope to address its complexity. However, some argue that Greenspan is wrong and crisis that threatened the foundation of the American economy, led to soaring unemployment, a continuing foreclosure crisis and weakened economies in the USA and Europe. It would have been a grave mistake not to address problems of inadequate regulation and lax oversight (Barney Frank, 2003). Hence, the arguments for and against the actions to be taken to prevent financial crises are different.

Based on these crises, the following lessons can be highlighted for regulators and financial institutions to overcome or at least

to reduce adverse impacts from possible crises:

(i) Many financial crises have taught the necessity of strengthening regulations to tackle the behaviour of financial institutions. From the US crisis, it was emphasised that regulations are required to tackle institutions that are too big to fail. From the recent financial crisis, it appears that the weaknesses in regulatory mechanisms fuelled failed financial institutions and led to a financial crisis which had wider repercussions. The regulations are required, not only to regulate financial institutions, but also to regulate new products such as derivatives, to evade troubles. Further, these laws increase transparency through new financial services that will give powers to regulators to access information about the entire financial system. The mechanisms such as Basel II, Basel III, etc. also have imposed some capital requirements which will ensure the stability of institutions. These mechanisms are ex-ante preventive measures anticipating possible weaknesses in advance. However, some may argue that these regulations may impose controls preventing the liberalisation philosophy.

(ii) The Asian financial crisis was erupted due to poor economic "fundamentals". The nations exposed themselves excessively to speculative movements of capital and short-term capital flows, with no regulations and controlled mechanisms affected the most. This was purely because of the prevailing philosophy of openness to all kinds of financial flows. Therefore, regulators have to be careful. The fact is that Asia became very dependent on foreign investors whose concern was not whether a country had its fundamentals in order, but what other speculators were thinking. This created a very volatile structure and ultimately a chain

reaction of crises. Short-term foreign borrowing increases vulnerability to shocks. The short-term flows coming in can quickly flow out. Thailand was an example for this where withdrawals of short-term finances created the financial crisis in South-East Asia. At present, the IMF supports imposition of controls on short-term finances.

(iii) The crises have taught us the necessity of proper macroeconomic management. In that, controlling inflation, prudent exchange rate management, deficit financing management have shown great importance. Some small economies such as Singapore and New Zealand have both liberalised capital accounts and floating exchange rates under their macro-economic framework. In these countries, institutional arrangements exist to limit the incentives for excessive risks taking. In Singapore, this is done through supervision and regulation. In New Zealand, there is an emphasis on transparency and managerial accountability to stock holders and public at large. Accordingly, under macro-economic management, proper external and internal economic management has to be in place to avoid crises and the necessity for carefully designed monetary policies which manage inflation and liquidity has been emphasised. In a number of financial crises, the regime shift of exchange rate has led to financial crises. To prevent this type of crises, proper management of external accounts including exchange rates and the external reserves is required.

(iv) The crises which led to reduce expenditure of households ended up with recessions. When there is a crisis, restrictions in the monetary side and credit will take place, resulting in a decline in

demand for goods and services. These measures may impose restrictions on small- and medium-sized enterprises. The US crisis, which provides an example, led to reduce consumption of the households and resulted in a drop of demand for goods and services produced by firms. This ultimately led to a world-wide crisis, adversely affecting exports of emerging economies while it created a recession in many countries including the USA and the UK.

(v) Another lesson that can be learnt is the avoidance of overreaction to short-term developments. This may be relevant to domestic sector or to external sector activities. Korea, at end of 1997, experienced a sharp exchange rate devaluation which was largely unanticipated. This triggered an unprecedented banking crisis. Therefore, countries should consider long-term perspectives rather than short-term goals when they consider monetary and fiscal management.

(vi) The effects of the crisis are long term and costly. Many countries happen to spend a lot of taxpayers' money to rescue failed financial institutions. This was clear from the US crisis that billions of dollars were pumped from the government to bail out failed institutions. This was not limited to the USA, but also to many countries in the world that came up with financial assistance from the governments to rescue financial institutions both in the government and the private sectors. Even in Sri Lanka, during the period where there was a distress in the financial companies, the government (Central Bank) extended financial assistance to rescue finance companies from collapsing.

(vii) It is required to have sufficient supervision and adequate public disclosures to prevent the failure of financial institutions. Strong measures have

been implemented by many countries to strengthen supervisory activities, while countries such as the USA and those in G20 came up with strong legislation to strengthen the supervision. Financial institutions should respond to this supervision favourably to prevent possible collapses. Even in Sri Lanka, prudential supervision and timely action on financial institutions protected the country from the adverse effects of the several crises that occurred around the world. Because of the strong supervision and timely measures implemented in Sri Lanka, the country was able to protect itself from adverse effects of the South-East Asian crisis and the US crisis. The measures implemented included issuing guidelines/instructions/directions on capital and credit ratios, corporate governance, non-performing loans, business continuity plans, payments to imports, and limits of remuneration for bankers, commencement of risk-based supervision, implementation of Know Your Customer (KYC) policy, introducing limits on commercial banks' borrowings, and appointing management committees for financial institutions. The Korean financial crisis in 1997 was due to lax of provisioning, poor standard of concentration of risk and large exposures, lack of good internal liquidity management controls, and weaknesses in supervision and regulatory arrangements. Therefore, financial institutions should respect to supervision and regulatory arrangements to avoid future crises.

(viii) To protect the depositors, mechanisms such as Deposit Insurance Schemes provide favourable grounds to avoid adverse effects of the crises. In 1996, Japan came out with a deposit insurance scheme. In Sri Lanka too, provisions were made recently to establish a deposit insurance scheme. This move, which may be a part of risk management, provided authorities with improved flexibility

to deal with failed financial institutions. The IMF has stated that world's largest and most important banks should pay additional fees to address the risk of liquidity shortfall in their institutions that may cause wider damage to the financial system.

(ix) Private financial institutions also should act proactively to regulators' actions. The perception that official resources can be used to bail out creditors generates moral hazards. It could lead to excessive risk taking by lenders and funding of less economically defensible projects and may aggravate the possibilities of crises. After the adverse experiences of the recent crisis in the USA, regulators are considering imposition of regulations to limit gearing capacity, enhance capital adequacy, and to conduct stronger stress tests on financial institutions. The private sector responses to governments' or the regulators' actions are required to prevent crises.

(x) Financial Institutions, especially banks, should carefully arrange investment portfolios drawing attention to both liquidity assets and profit-generating assets to maintain public confidence which is very important for their functions. Liquid assets and profit-generating assets have two ends, and their proper maintenance may ensure confidence of the public as well as profits of the financial institutions. The global financial crises have taught lessons emphasising the importance of maintaining a healthy financial system based on public confidence and generating profits.

(xi) Today, the handling of risk exposures of financial institutions plays a very critical role for their survival. In the current world, types of risks are different. Financial institutions have to tackle many types of risks to maintain their credibility, and hence, risk management has become very essential. Adverse risk management is partly responsible

for the US financial crisis in which a number of financial institutions failed due to poor risk management. Maintenance of transparency is also a part of the risk management. The dealing with sophisticated derivative products which was the main cause behind the US crisis carried enormous risks to financial institutions. Therefore, financial institutions should pay attention, not only to current risks, but also to future risks.

(xii) One of the prominent characteristics behind financial crises has been the insufficient awareness of the financial products and activities of financial institutions. During the crises, it was evident that the staff of the financial institutions as well as the general public did not have proper knowledge of the financial products. The general public usually goes for high returns without considering much the security of the assets. This can create substantial losses to the depositors. The awareness of the staff members of the financial institutions on various developments is also essential when the functions of financial institutions are carried out. A team of well-qualified and experienced staff is required for financial institutions for which training and capacity building are essential.

(xiii) Some crises have erupted due to political reasons. The crises occurred with this background have created unemployment and problems in income distribution resulting in changes in political environment. For instance, in Thailand, the Prime Minister was forced to resign and President Suharto in Indonesia stepped down after 32 years of autocratic rule. South Korea also had political changes. In South Korea the autocratic government of Kim Young Sam was replaced by relatively untainted regime of Kim Dae Jung. So, the lesson learnt from this is that financial crisis may lead to a political crisis as well.

(xiv) Crises have shown the importance of international relations. A country alone cannot tackle a crisis. The crises such as in South-East Asia and the USA have proved the necessity of international action to avoid their adverse effects. The USA requested co-operation from Europe to tackle the financial crisis which had global repercussions. A number of countries in Europe responded to this by adopting parallel monetary and fiscal policy measures. A number of countries provided financial assistance to affected financial institutions. The reduction in the interest rates was one of the combined monetary policy measures adopted by many countries which helped in resolving adverse repercussions of the US crisis. Therefore, to tackle a crisis, international co-operation is required. Some argue that casualties of financial crises have come due to lack of North-South dialogue. It is said that a lack of North-South dialogue has put the whole burden of effects of financial crises on the developing countries.

The above-mentioned lessons can be treated as global lessons that we have learnt from the crisis situations. Sri Lanka was not adversely affected due to the recent crisis in the USA because of available improved macroeconomic situation, favourable regulatory background, prudent supervision and the timely action taken by relevant authorities. The Governor of the Central Bank of Sri Lanka highlighted ten lessons learnt from the financial crisis, as given below:

(i) Be prepared in advance: This is having to wear a life vest when the storm is coming when someone is on the deck. The action taken to introduce one percent general provision to all banks was one of the measures that the Central Bank took in advance, prior to the crisis.

(ii) Develop the ability to move quickly and decisively: The central bank gave clear signals on what exactly it was going to do. This prevented the impact crisis.

(iii) Read and realise the global developments quickly: For this, proper information was required and the Central Bank watched global developments such as crashing of big financial institutions and economies in the world.

(iv) Take a long-term view of the factors and take measures accordingly.

(v) Deal clearly and decisively: In this, it is required to tell clearly what is to be done by the stakeholders.

(vi) Implement package of policies without relying on one. Central Bank had multiple plans to deal with the problems that it faced with regard to international reserves.

(vii) Work closely with the government, the political authorities: This is required to achieve a common goal and to implement strategies accordingly.

(viii) Take advantages of opportunities in the market: The Central Bank built up not only the domestic currency market, but also the capacity of foreign currency market in Sri Lanka.

(ix) Think rationally of the law of unintended consequences: For instance, imposing a tax on gold reduced gold imports substantially in Sri Lanka.

(x) Address global problems in a globalised manner: The Central Bank took action to take up the issues as and when required with the IMF. So, granting of additional SDR (Special Drawing Rights) allocations to countries was one of the outcomes of this.

Although the above text indicated ten lessons from the financial crises, it is necessarily not needed to limit it to ten.

Conclusion

This paper attempted to classify financial crises in some order, find out causes of financial crises, while explaining the USA sub-prime mortgage crisis in 2007 with consequences of this crisis, and explaining the history of financial crisis in Sri Lanka. Finally, it highlighted lessons which were learnt from the crises. Examples were provided from many financial crises, such as Mexican crisis, South-East Asian crisis, Ireland financial crisis and the latest from the sub-prime mortgage crisis in the USA to identify the causes of financial crises. The paper identified the failures of financial institutions and the actions taken by authorities to resolve the adverse effects of the crises.

The paper highlighted many lessons that could be learnt from the crises. The need for and/or importance of regulatory requirements, macro- and micro-economic frameworks, supervision, mechanisms such as deposit insurance to mitigate risks, a proactive role of the financial institutions, managing portfolios and risks and a team of skilled staff for financial institutions to avert/manage financial were highlighted. It also showed that there were political reasons for some financial crises, and international relations to avoid adverse impacts of the crises were important. The paper finally indicated some actions that helped Sri Lanka to avoid repercussions of financial crises.

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