

The international financial crisis: questions for some lessons

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Abstract

This paper aims to explore the most important sources and implications of the current international financial downturn while analyzing and discussing a recently published book on finance by Professor Michel Aglietta, written in 2008, in which the author expands on the sources of the current international financial crisis and suggests several possible solutions. In particular, while analyzing Aglietta's answers to ten questions, we examine, firstly, the most important microeconomic sources (i.e. governance problems, market imperfections, audit and new international financial reporting standard limitations) and macroeconomic explanations (i.e. the impact of the Asian crisis and the development of emerging models) for the current financial downturn. We then investigate the most notable features and characteristics of the current crisis. Finally, we identify the most widely expected economic, social, political and geopolitical outcomes of the present market turmoil and explain what we expect the financial world to look like once the crisis is over.

Keywords: Financial Crisis, Financial Markets.

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1. Introduction

The current international financial meltdown that has affected most emerging and developed countries is the subject of a number of theoretical and empirical studies (Allen and Gale, 2007; Aglietta, 2008; Greenlaw *et al.*, 2008; Mian and Sufi, 2008, Reinhart and Rogoff, 2008; Shiller, 2008; Jawadi, 2009; Arouri *et al.*, 2009, Arouri *et al.*, 2010 among others). These studies mainly focus on key issues such as: “what are the sources of this crisis?” and “What are its most important consequences?”

In general, the authors of these studies point the finger of blame at the subprime crisis and the global credit crunch as the main origins of the international financial crisis. In particular, the authors identify the underlying microeconomic and macroeconomic factors. On the one hand, these cover microeconomic factors associated with the use of the new IFRS norms, the “market to market” evaluation method, the “originate and distribute” evaluation method, subprime credits, “credit default swaps,” the VaR model, “titrization,” etc., which significantly increased credit demand and, subsequently, financial asset prices. Consequently, the credit market rose far more than wealth as it matched stock price trends. In addition, the risk associated with credit and its subsequent insurance decreased to low levels since the probability of a crisis seemed very low.

On the other hand, macroeconomic and external factors associated with Fed strategies (e.g. interest rate variations and measures regarding the US real estate market), the parity variation of the US \$, the Asian crisis and the recent boom in emerging economies among others led to and amplified the global financial crisis, which had a rapid and powerful impact on the financial systems of both emerging and developed countries worldwide.

To overcome the present downturn, restore market confidence and find a way out of the crisis, it appears crucial to restructure the institutional foundations of the financial systems. Bringing in new regulations, reviewing trading and banking services and activities, and developing joint monetary and budgetary policies and cooperation are clearly recommended if we are to save the economy and the financial systems from similar crises and dangers in the future.

This paper sets out to discuss and present the main ideas developed by Aglietta (2008) regarding the financial crisis, with a focus on three aspects: the key sources of the financial crisis, its consequences, and further solutions. The remainder of this paper is organized as follows. We first discuss the financial crisis and its mechanisms. We then present its main consequences. And finally, we discuss some possible solutions.

1. Is the current international financial crisis inherent to the market economy?

According to studies by Kindleberger, financial cycles seem to go through five main phases. Firstly, a flight phase characterized by a significant increase in financial asset prices, transaction volumes and wealth. The excess in financial asset overvaluation then leads to a financial crisis, notably when price levels reach some form of paroxysm that induces an obstruction and excitement phase. The latter provokes a third phase of fear and chaos in investor behavior and prices, inducing panic throughout markets and institutions. To reassure investors and overcome this phase, the market requires a fourth phase of funding in which all the indicators and wealth need to be devaluated and investors no longer invest much, and this can sometimes lead to an economic recession. This kind of phase is not only laborious but also very long. Finally, a phase of correction occurs when investors again find investment opportunities.

According to Aglietta (2008), the succession of phases is neither absolutely periodical nor a physical phenomenon, but is, in fact, endogenous to financial cycles and inherent to financial practices and economic and financial systems. More particularly, the phenomenon occurs when investors make excessive, high-risk and irrational gambles, at the same time demanding considerable profit.

2. Why didn't we foresee the financial crisis?

There are usually some indicators that send out alerts regarding the risk associated with an increase in credit, notably when credit increases far more than incomes. Such alerts may be activated when credit costs are low but their volumes are increasing rapidly, for example. However, over the last few years, the increase in credit has been lower than that of financial asset value. The use of the new International Financial Reporting Standards (IFRS) introduced a new method of evaluation known as "Market to Market." The latter compares credit with financial assets which are largely over-valuated. Consequently, even if credit increases rapidly and reaches very high levels, this may not be visible since it is guaranteed by market quotations.

3. What are the features of the present crisis?

The current international financial crisis has several key features. The first characteristic is the high level of credit that led to an accelerated overvaluation of financial and real estate assets. In order to reduce the risk associated with this credit, investment banks applied the

“market to market” evaluation method and developed a number of derivative products such as the “Credit Default Swap,” known as the CDS. The CDS enables banks to sell and transfer risk associated with credit, while freeing up large capital flows for bankers. In effect, by transferring the credit-related risk to other financial institutions, banks no longer have to keep capital in reserve and can in fact continue to invest it even as they borrow it and thus multiply the same credit. This also led to strong overvaluation of financial assets and a weakening of the capital cover, however. The second characteristic is linked to the new credit risk evaluation methods used by several business banks such as value-at-risk, known as VaR, that yield statistical indicators to evaluate the demand for credit. In fact, VaR simply defines a few default probabilities that may not rigorously assess the real risk. Thus, bankers simply “originate and distribute” credit. However, this method of credit risk evaluation led to a deterioration in the credit devaluation process, and the volume of credit consequently took precedence over the quality of the credit.

4. How was the crisis triggered?

After the Asian crisis in 1997, several emerging countries changed their functioning models and their strategies and rapidly switched their financial systems to make them more capital exporter-driven than importer-driven. At the same time, the strong growth in China and India led to price stagnation in developed countries. On the other hand, following the internet bubble, the US financial market was strongly devaluated and US firms became highly indebted. The Fed therefore tried to stimulate the economy while keeping the interest rate very low. A radical transfer of debt from business to households was observed, bringing with it more US consumption but a reduction in savings and, subsequently, less US production capacity.

Consequently, there were far more exports from emerging and Asian countries toward the USA. More interestingly, most of these countries transformed the income from their exports into US Treasury loans, US real estate agencies and US business banks. This meant that the Fed lost control of liquidity, which was increasingly stimulated by the capital from emerging countries that in turn demanded more US financial assets.

At the same time, interest rates had been low for a long time, and credit demand increased rapidly and significantly. Demand for real estate prices also rose considerably, as did prices until 2006, leading to a huge real estate bubble in the US in 2007. Among the credit lines available were the infamous subprime loans that were granted to high-risk US households in order to allow them to buy property. However, real estate prices began to fall at the end of

2006, signalling a turning point when householders no longer invested or bought houses. Taken together, these factors triggered a US financial crisis that rapidly spread worldwide.

5. Is this crisis international?

The US financial downturn induced by the subprime crisis rapidly spread to other emerging and developed countries for several reasons. The transmission of the crisis became systematic in 2008 when business banks began showing signs of weak liquidity, coupled with a phenomenon of bankruptcy. Lehman Brothers was a prime example. Thus, the weakness and insufficiency of liquidity coupled with the subprime crisis induced an international financial meltdown. Indeed, the US crisis affected business banks with several activities in the US market.

On the whole, economists and policymakers assumed that emerging countries and Chinese banks, which respectively had strong growth and had taken less risky positions than the US, could escape this crisis. However, the financial systems of many of the emerging countries, such as Mexico and Argentina, were strongly dependent on American business banks (Arouri *et al.*, 2010). The downturn of the latter affected their exchange rates because of the devaluation of the US \$, and thus the financial crisis was also severely amplified in these countries. Consequently, the market interest rate financing loans between banks quickly climbed to 6% while the Treasury bill rate was about 2%, reflecting the extreme tension in the monetary market and leading to a global blockage in bank financing. The crisis thus led to a real recession for western countries, although just a slowdown for emerging countries, and, according, to Aglietta (2008), financial globalization is likely to continue.

6. What were the effects of the financial crisis on economic activity?

The present financial crisis had two immediate consequences: less liquidity, and credit that was much more difficult to get and more expensive. Thus, damaged bank balances, and reduced investment and consumption induced a slowdown in economic activity and negative growth. The latter may well persist for several years (three to four years according to the IMF).

The decrease in consumption led to a fall in firms' profits and a weakening of their financial structures, resulting in higher unemployment. To try to turn this situation around, governments injected more cash to help prop up the banks, and the central banks decreased their interest rates several times. However, this also aggravated the indebtedness of these countries and burdened their public deficits.

7. How to manage the financial crisis?

At the origin of the crisis, the US government was the first to act by injecting about 200 billion US \$ to try to help two major US real estate agencies, Freddie Mac and Fannie Mae, before nationalizing them. However, when Lehman Brothers, one of the stalwarts of Wall Street, went bankrupt on September 15, 2008, it quickly triggered panic on the US markets, rapidly followed by the European markets, resulting in serious cash flow problems for banks that consequently amplified the financial crisis.

In order to deal with the crisis, several central banks tried to stimulate market liquidity by decreasing their interest rate several times, and lending money directly to firms. This had a major impact as the Fed treasury bills, for example, fell from 95% to 50%. However, this was insufficient since central bank interventions only stimulated liquidity but did not resolve the fundamental problems regarding bank capital and doubtful debts. To cover the latter, governments placed their guarantee behind banks. The European countries injected €1700 billion to guarantee bank credit, for example, while the US government provided a 700 billion \$ rescue package to purchase the depreciated financial assets, leading, of course, to a massive increase in public debt. Thus, the expected budgetary deficit in the US stands at around 8% for 2009.

8. Did the financial crisis increase European cooperation?

The Fed and the ECB did not take the same decisions with regard to the internet bubble, but the current international financial crisis pushed the US and European monetary authorities to act in harmony. It also galvanised European cooperation as in the cases of the bankruptcy of Fortis (Belgian–Dutch group) and Dexia (International financial group) when the financial problems of both banks were examined by France, Luxembourg and Belgium.

Thus, the financial crisis pushed European countries to forget their divergences and differences but, unlike the US, each European country has its own budget. The absence of a unique European banking control centre means that their decisions can be smoother. However, to improve European cooperation, a strong common budgetary policy is now indispensable as the financial crisis has symmetrically and significantly affected the financial systems of all the European countries. A common federal budget is needed for this purpose as well as improvements to the European Union institution and the European parliament.

9. Is it necessary to introduce new regulations?

It is worth noting that credit control will henceforth be an interesting and key element if the potential replication of financial crises is to be limited. New regulations need to be imposed on banks to increase their credit line provisions so as to control the growth of credit and en-

sure banking liquidity. These regulations should be introduced throughout financial systems worldwide so as to develop common standards for investors and ensure better international financial governance.

10. What banking regulations for tomorrow?

Present banking regulations incite traders to take too many risks, often in the short term, in order to obtain large premiums and bonuses. In particular, traders tend to subscribe to excessively risky positions as the risks they incur are not linked to their bonuses, and the maturation of the investment in the long term is not their responsibility. Thus, new banking regulations should firstly control trading activity adequately. Secondly, they should define the risks associated with trading more clearly in order to avoid some of the excessive risk associated with trading. Thirdly, stock options should be used only for long-term investment horizons. Fourthly, it is vital to clearly define an independent control system for management decisions, for example through a clear separation between the board of directors and the operational management. Thus, governance is a crucial issue that needs to be examined closely in line with the reforms to financial regulations.

Conclusion: What is the best economic answer?

This paper sets out to investigate a topical issue regarding the current international financial situation through an analysis and discussion of several questions developed by Professor Michel Aglietta in his recent book about the crisis. Overall, our analysis highlights the fact that the crisis is international, inherent to the market economy and that it requires several different solutions to be resolved: central bank intervention, much greater government cooperation, and new regulations and bank governance. The present crisis has led to an economic recession for several of the world's economies. To ensure that this recession does not become a depression, there needs to be far more coordination and cooperation between the authorities and national governments, through a significant and common expansive budgetary policy, for example, in addition to monetary actions by central banks. However, this may well generate two further effects: a reduction in the spread of growth between developed and emerging countries, and an excessive increase in government debt.

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