



Center for Social and Economic Research

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**The Global Financial Crisis:
Understanding the Fundamentals**

**Presentation for CASE Policy Research Seminar,
Warsaw, February 19, 2009**

Plan of presentation

- Sources and nature of the crisis
- Crisis dynamics
- Channels of contagion (to emerging markets)
- Crisis management and policy responses at core and periphery
- New challenges for economic research



Basic characteristic of the crisis

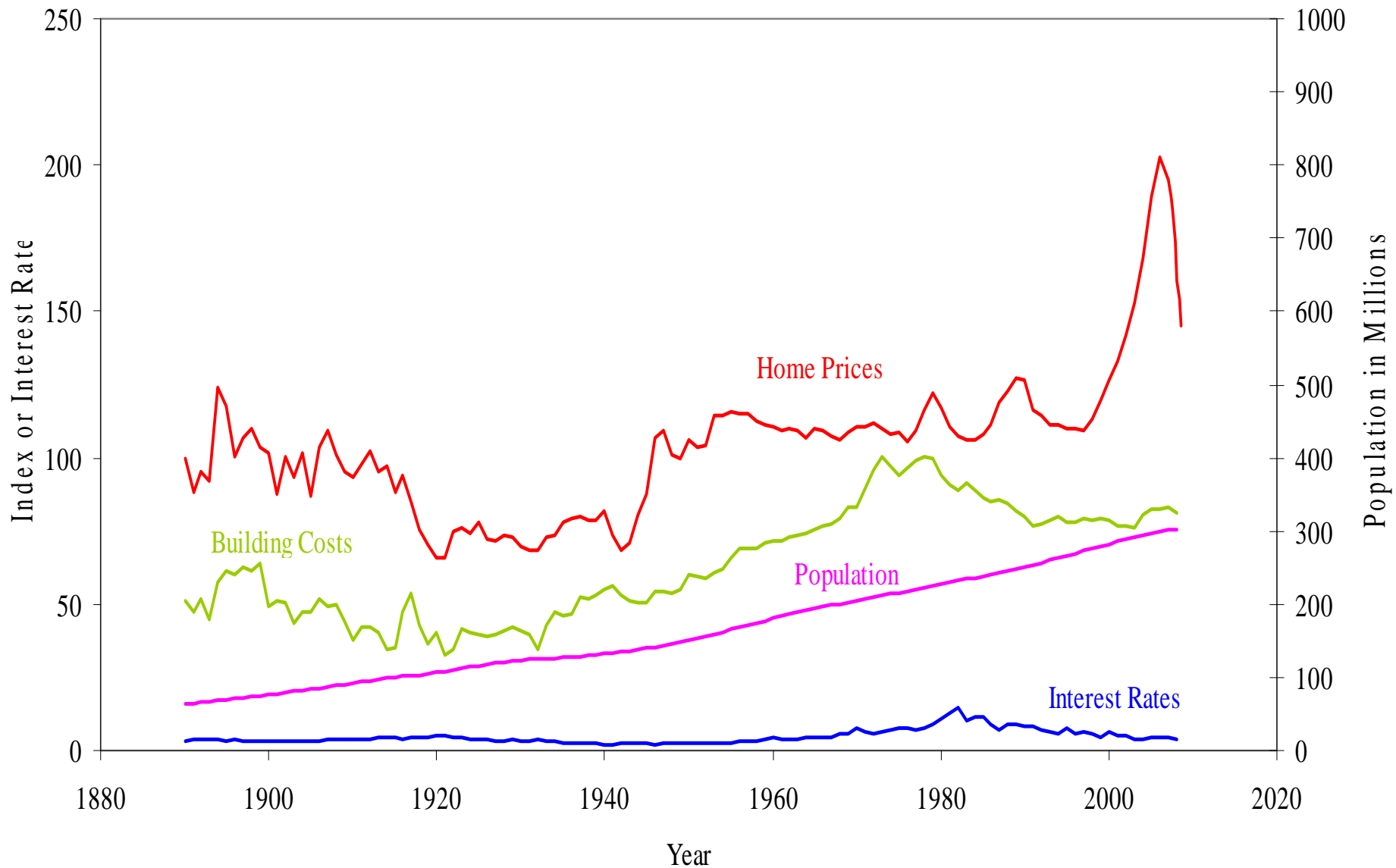
- Truly global financial crisis caused by bursting several bubbles
- Started at core and is moving towards periphery (opposite to 1997-1998 emerging market crisis and similarly to the Great Depression and 1972 US dollar crisis)
- Preceded by overheating of the world economy



Several bubbles

- Consumption bubble in US \Rightarrow Export bubble in emerging-market economies
- Liquidity bubble (large stock of NFA)
- Credit bubble
- Housing bubble in US and other countries
- Stock market bubble
- Commodity bubble





Source: Robert Schiller *Irrational Exuberance*, Princeton University Press 2000 and subsequent updates



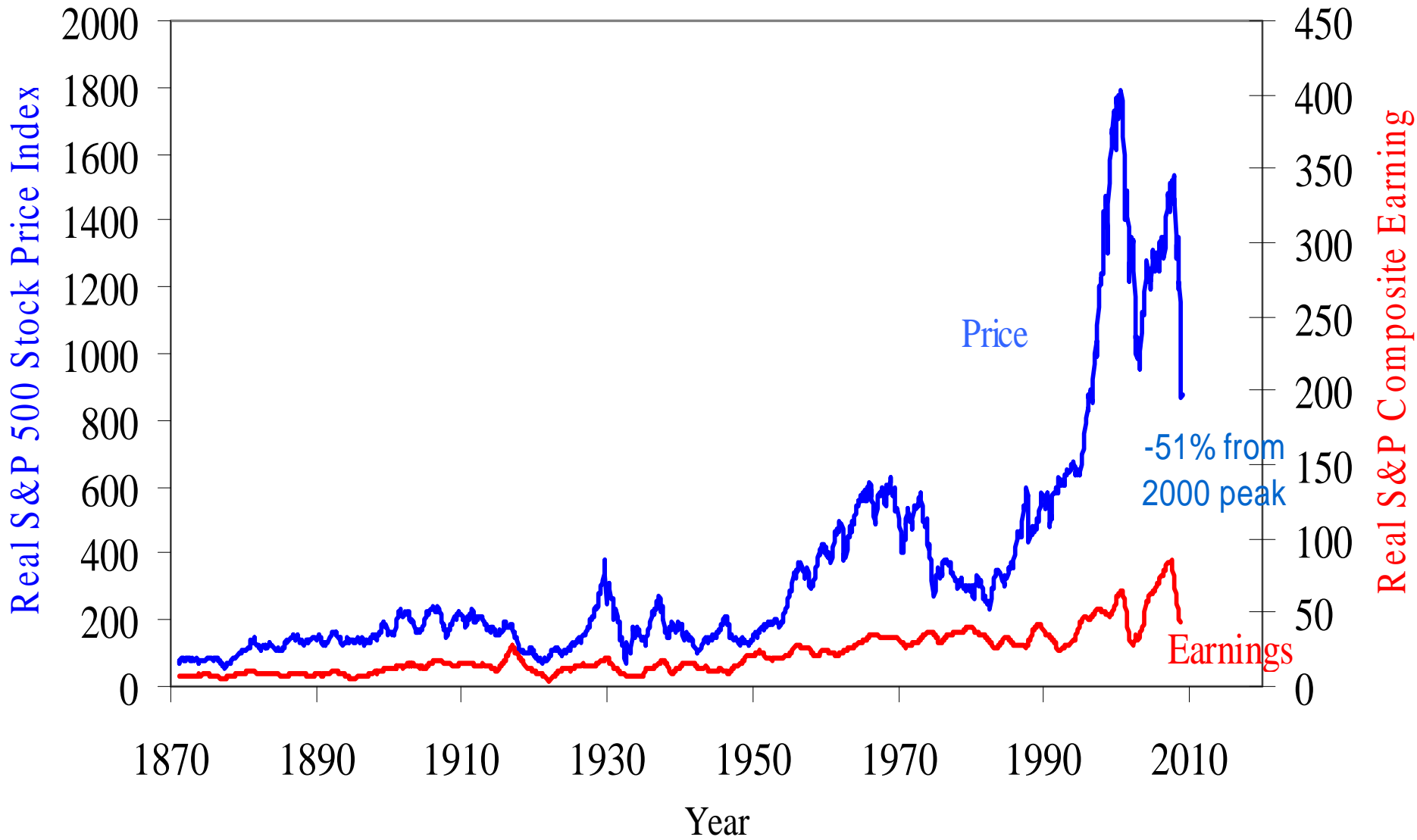
Case Shiller Composite Indices (Nominal)

— Composite 10 — Composite 20



<http://calculatedrisk.blogspot.com/>

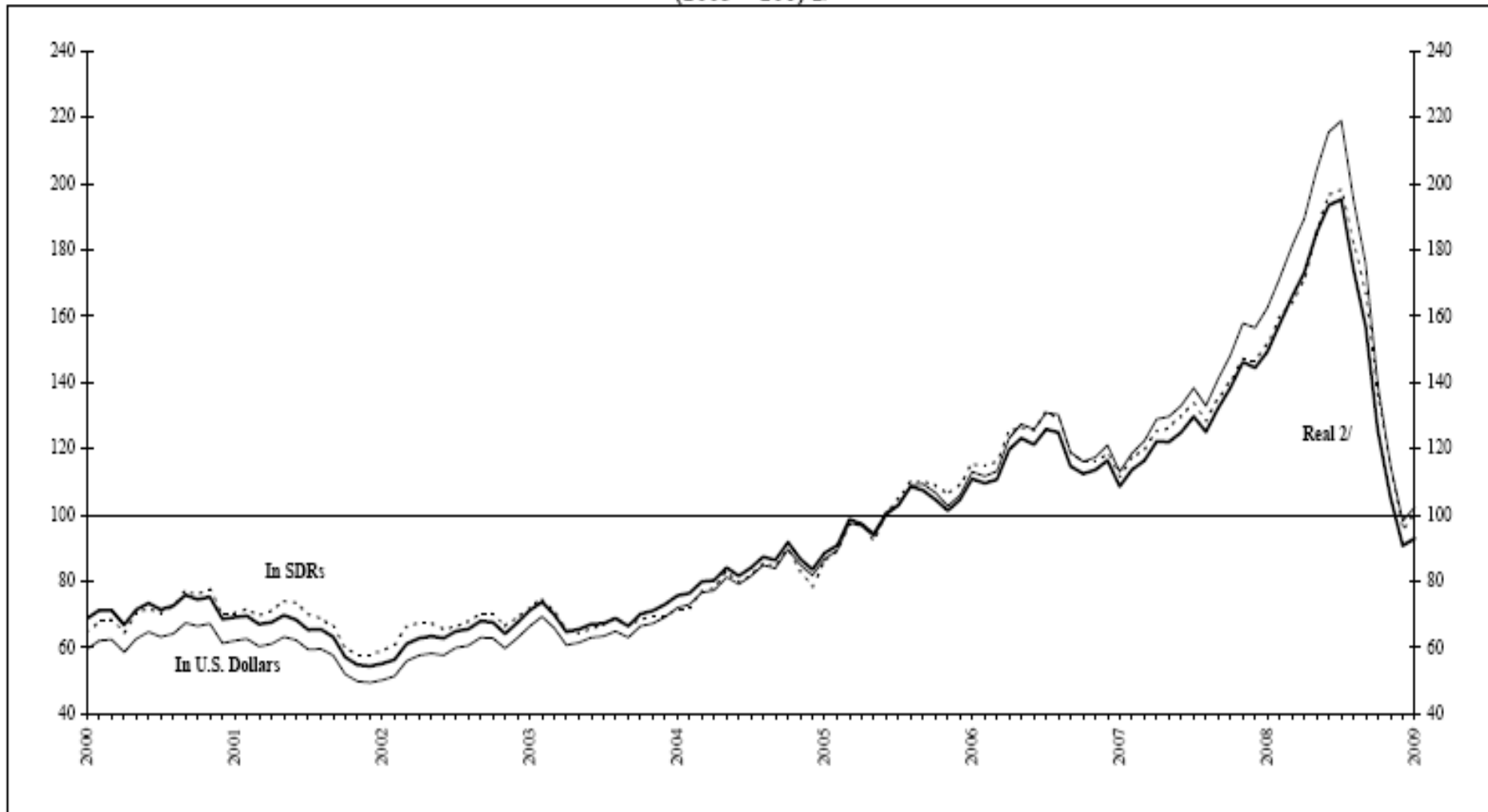




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CHART 1
INDICES OF PRIMARY COMMODITY PRICES
(2005 = 100) 1/



1/ Combines indices of non-fuel primary commodity prices and petroleum prices.

2/ Deflated by US CPI.

5-Feb-09

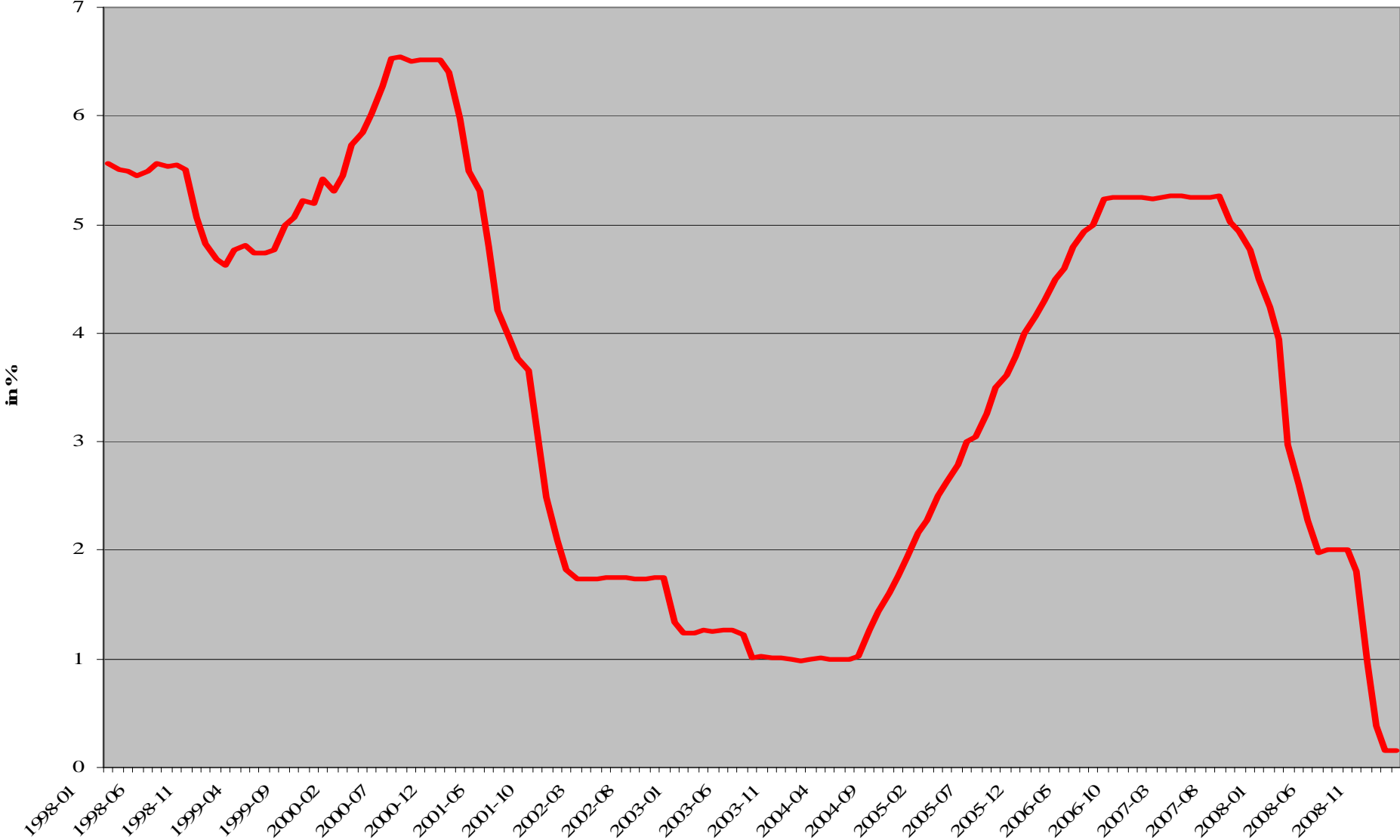


Factors responsible for building bubbles

- Highly accommodative monetary policy of the US Fed and other major central banks (fear of recession and deflation in US in early 2000s)
- Mercantilist policies of many developing countries backed by IMF recommendations to build precautionary foreign-exchange reserves
- Second-round phenomena (e.g. recycling of oil surpluses)



Fed Federal Funds Effective Rate

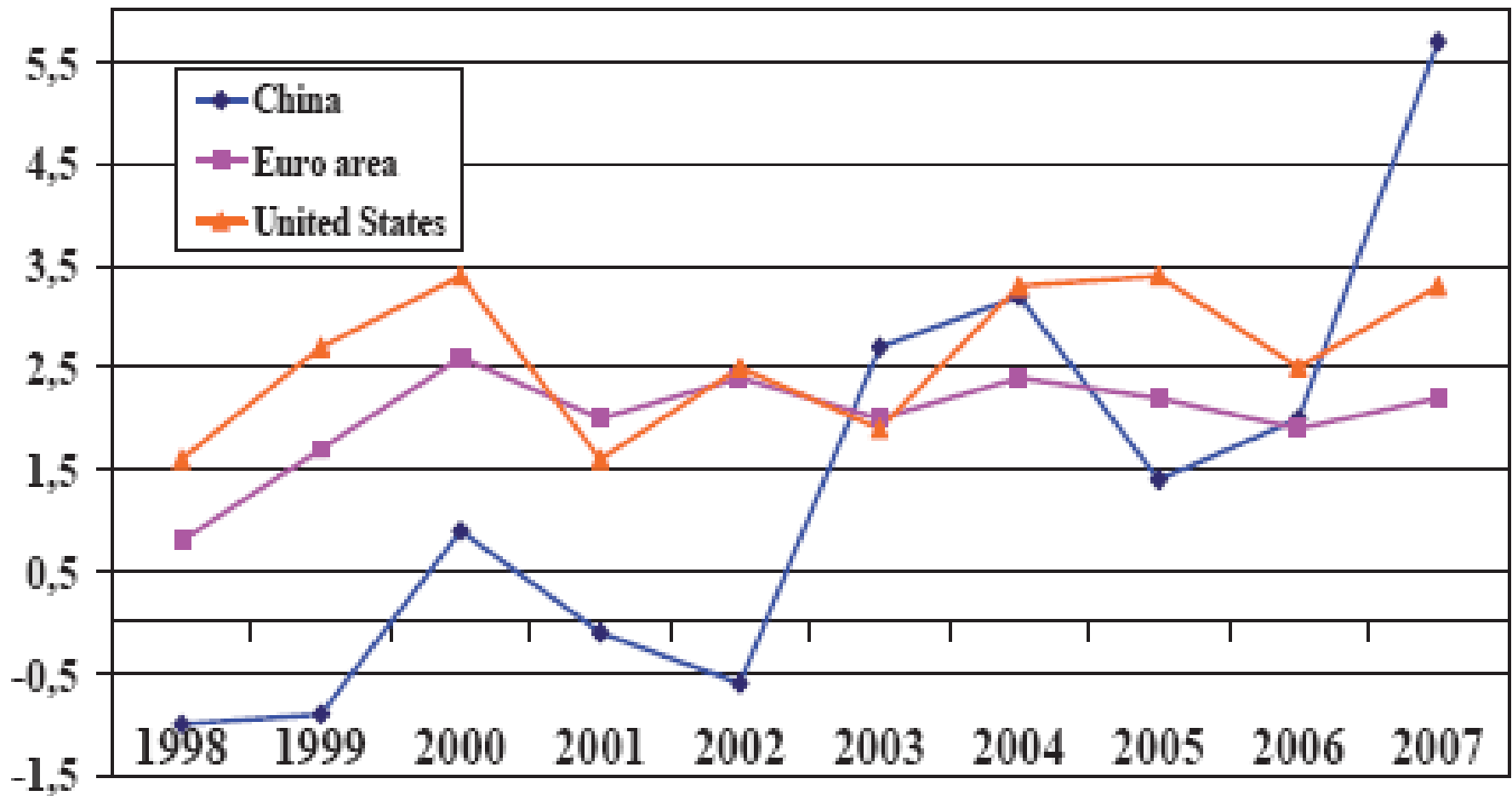


Delayed and limited inflationary consequences – why?

- Positive supply side shocks (effects of market transition in many developing countries and post-communist world) and global trade liberalization – downward price pressure
- Increasing demand for USD and EUR as global transaction currencies
- Post-inflationary remonetization in emerging markets (backed by international reserves)
- Absorption of excess liquidity by asset bubbles (asset prices are not covered by CPI)



End-of-year inflation in %



Source: <http://www.imf.org/external/pubs/ft/weo/2007/02/weodata/index.aspx>



Other institutional, regulatory, and microeconomic factors responsible for the crisis

- Lack of international coordination of macroeconomic (monetary) policies and financial supervision
- Sectoral segmentation of financial supervision
- Pro-cyclical prudential regulations (Basel 1 and 2)
- Risk assessment methodologies which were unable to follow financial innovations
- Wrong incentives schemes (remuneration of management in financial institutions, fees for rating agencies, etc.)



Crisis timetable

- Summer 2007: subprime mortgage crisis, beginning of collapse of stock exchange
- Early 2008: systemic crisis of financial institutions in US; economic slowing down in US, EU and Japan but continuing overheating in most of emerging markets (high commodity prices, weak US dollar, accelerating inflation)
- Summer 2008: a breaking point
 - Bursting of commodity and all other bubbles
 - Global crisis of financial institutions (bankruptcy of Lehman Brothers)
 - Recession in developed countries
- Fall 2008: crisis hits emerging-market economies

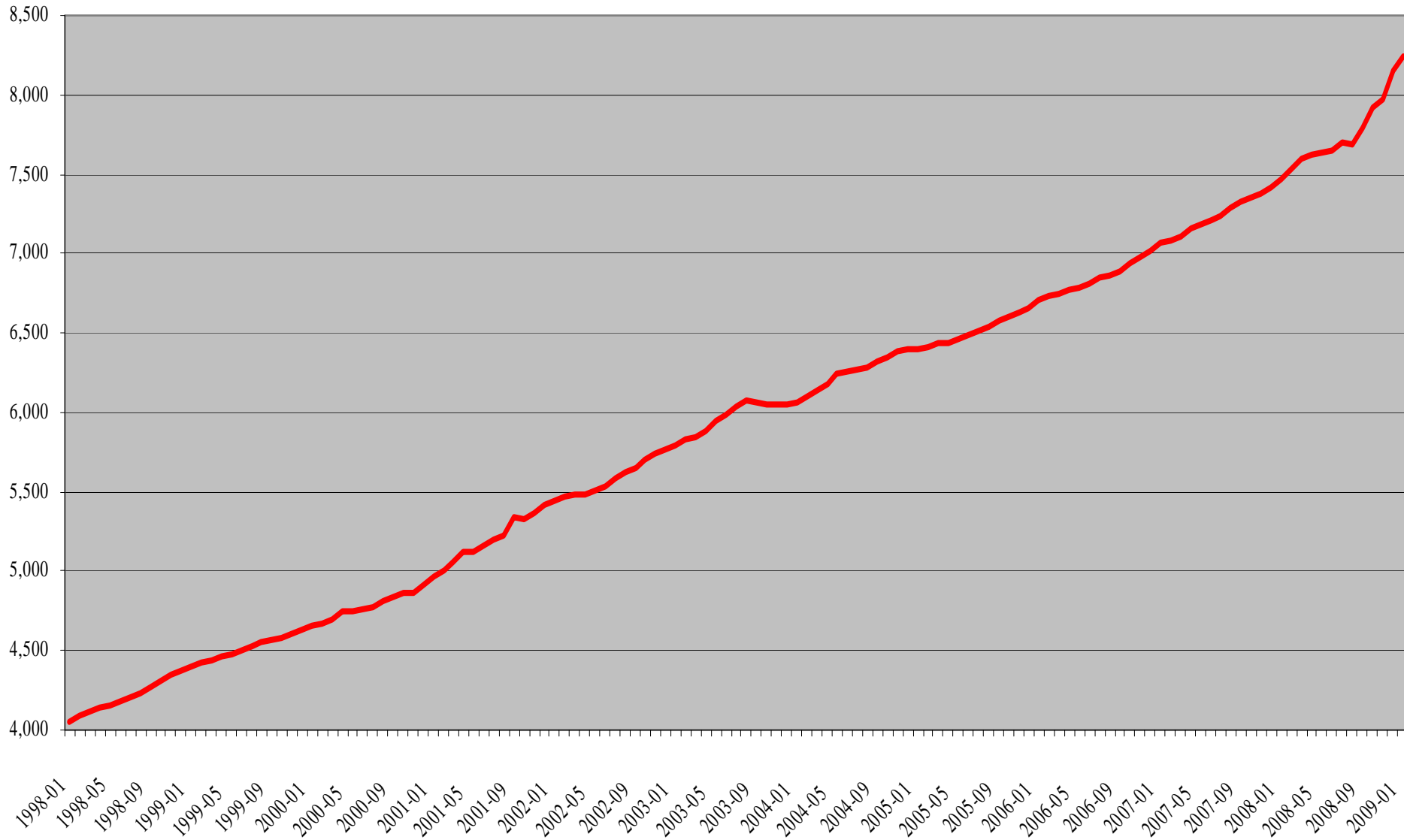


How crisis has been transmitted to emerging markets?

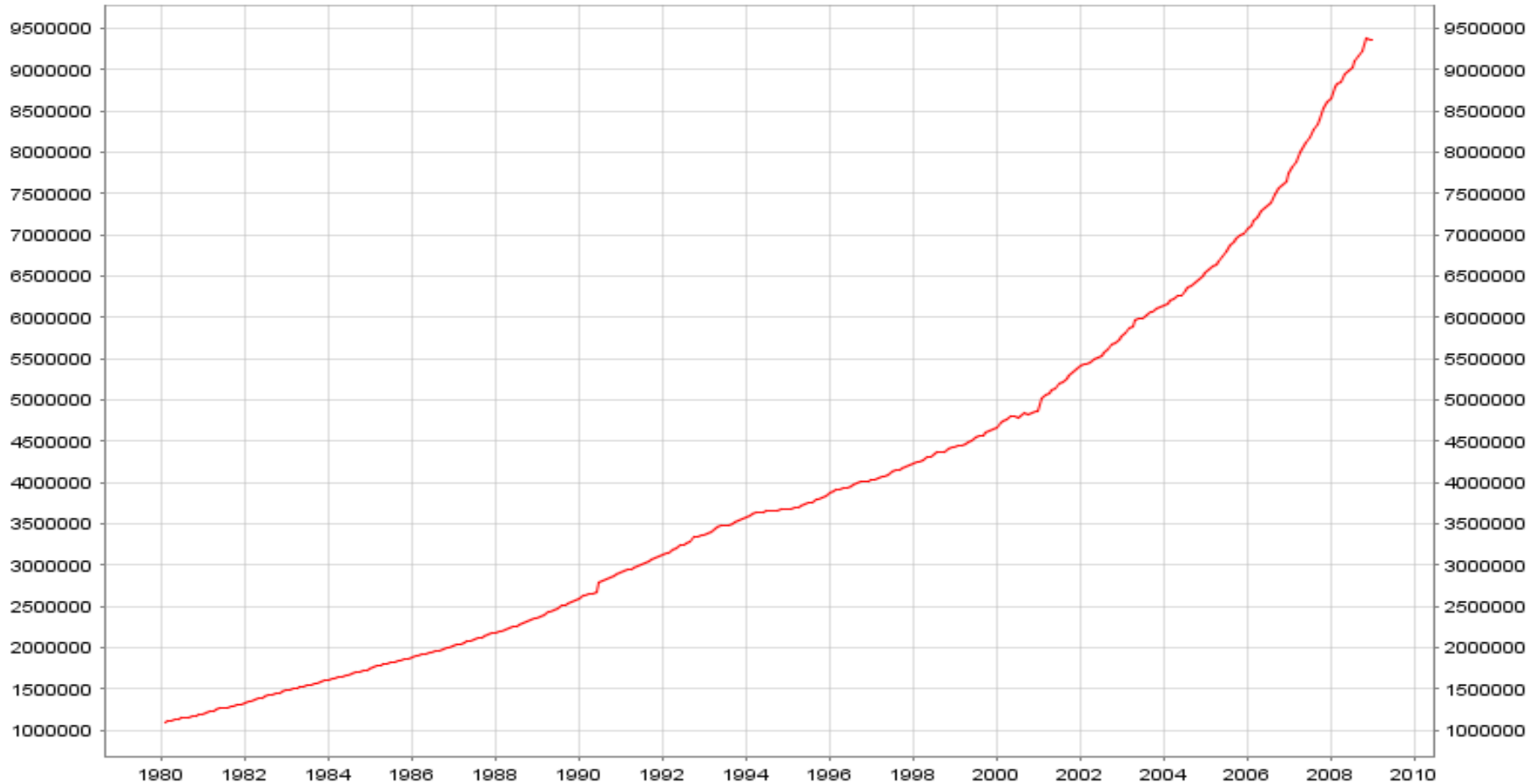
- Weaker global demand
- Fall of commodity prices
- Global liquidity squeeze
- Troubles of financial institutions
- Increasing risk aversion
- Increased exchange rate volatility
- Crowding out financial resources by fiscal stimulus
- Decreasing demand for labor migrants



Money supply in US (M2) in USD billion



Eurozone's M3 - stock



BSI.M.U2.Y.V.M30.X.1.U2.2300.201.E (Millions of Euro)



Eurozone's M3 – annual % change



— BSI.M.U2.Y.V.M30.X.I.U2.2300.Z01.A (Percentage change)



Table 1: BIS reporting banks

Summary of international positions

In billions of US dollars

Positions	Amounts outstanding			
	Dec 2006	Dec 2007	Jun 2008	Sep 2008
A. Total assets	29,472.5	37,450.7	39,087.8	37,562.8
claims on banks	18,242.3	23,356.2	24,415.6	23,456.6
claims on non-banks	11,230.2	14,094.6	14,672.1	14,106.2

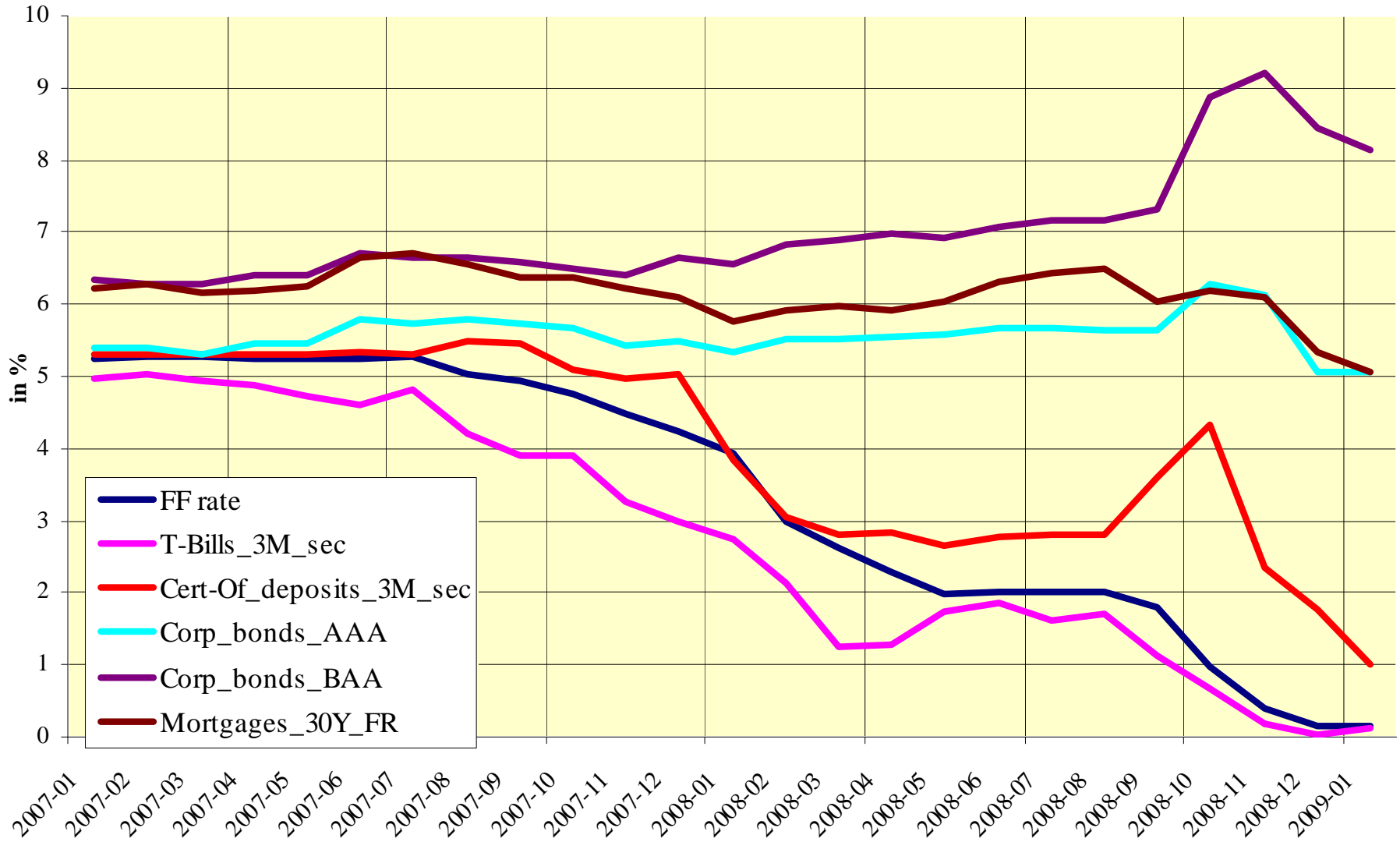


US anti-crisis policy - until LB bankruptcy

- Attempt to avoid recession
- Aggressive cuts in Fed rates (from 5.25% to 2.0%)
- Ad hoc supplying money market with additional liquidity (together with other major central banks)
- Fiscal stimulus (mostly tax cuts and assistance to mortgage borrowers)
- Last minute bailing out of banks
- Lack of long-term plan to rehabilitate financial sector
- Ignoring global effects of US economic policy decisions



Interest rate divergence -US market

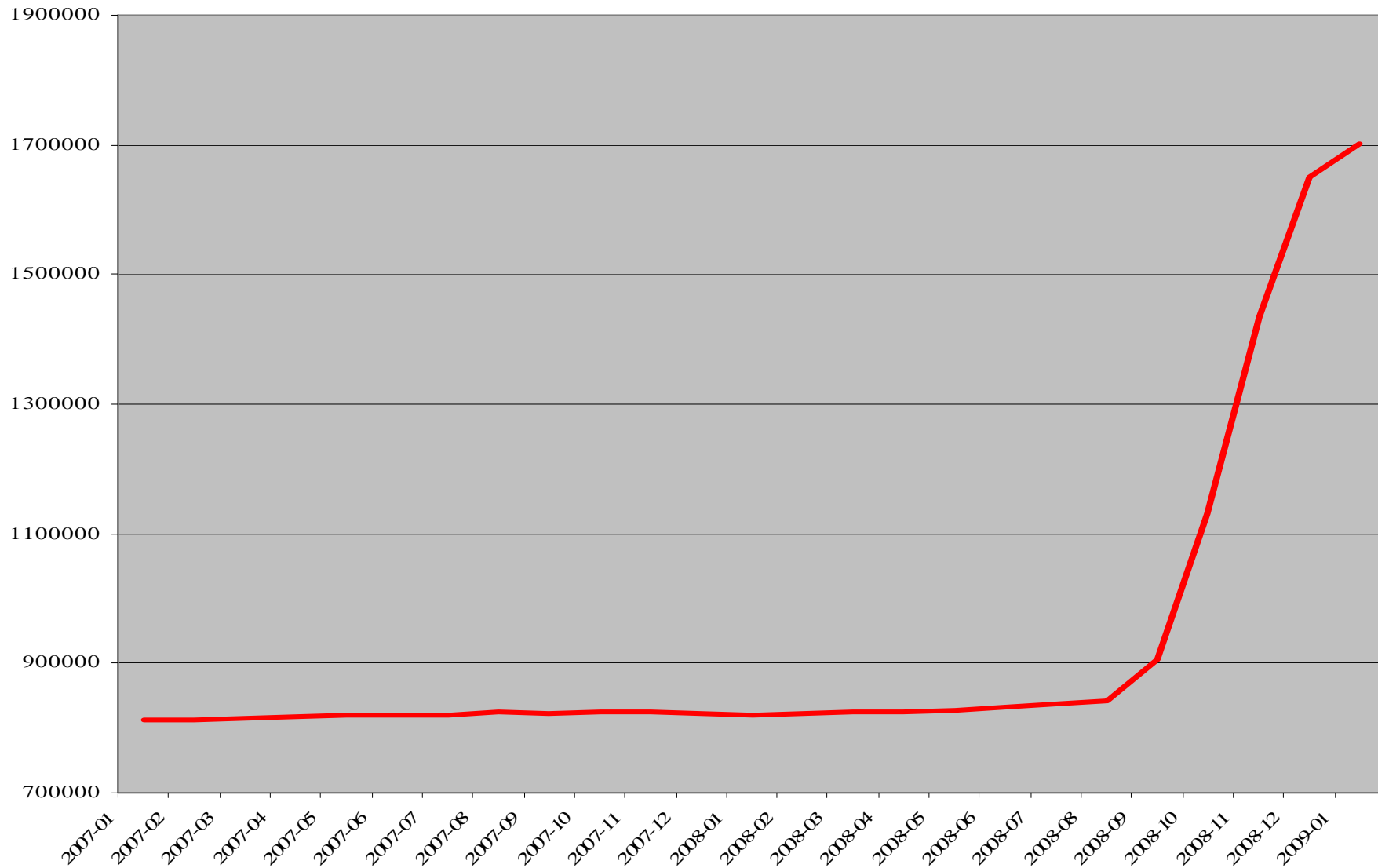


US anti-crisis policy - after LB bankruptcy

- Attempt to avoid deep recession and deflation and rehabilitate financial sector (still lack of a coherent plan)
- Quantitative monetary easing aimed to cushion collapse in financial intermediation
- Aggressive fiscal stimulus packages (various addressees)
- Last minute bailing out of banks
- Closer international cooperation



Fed Reserve money in USD million

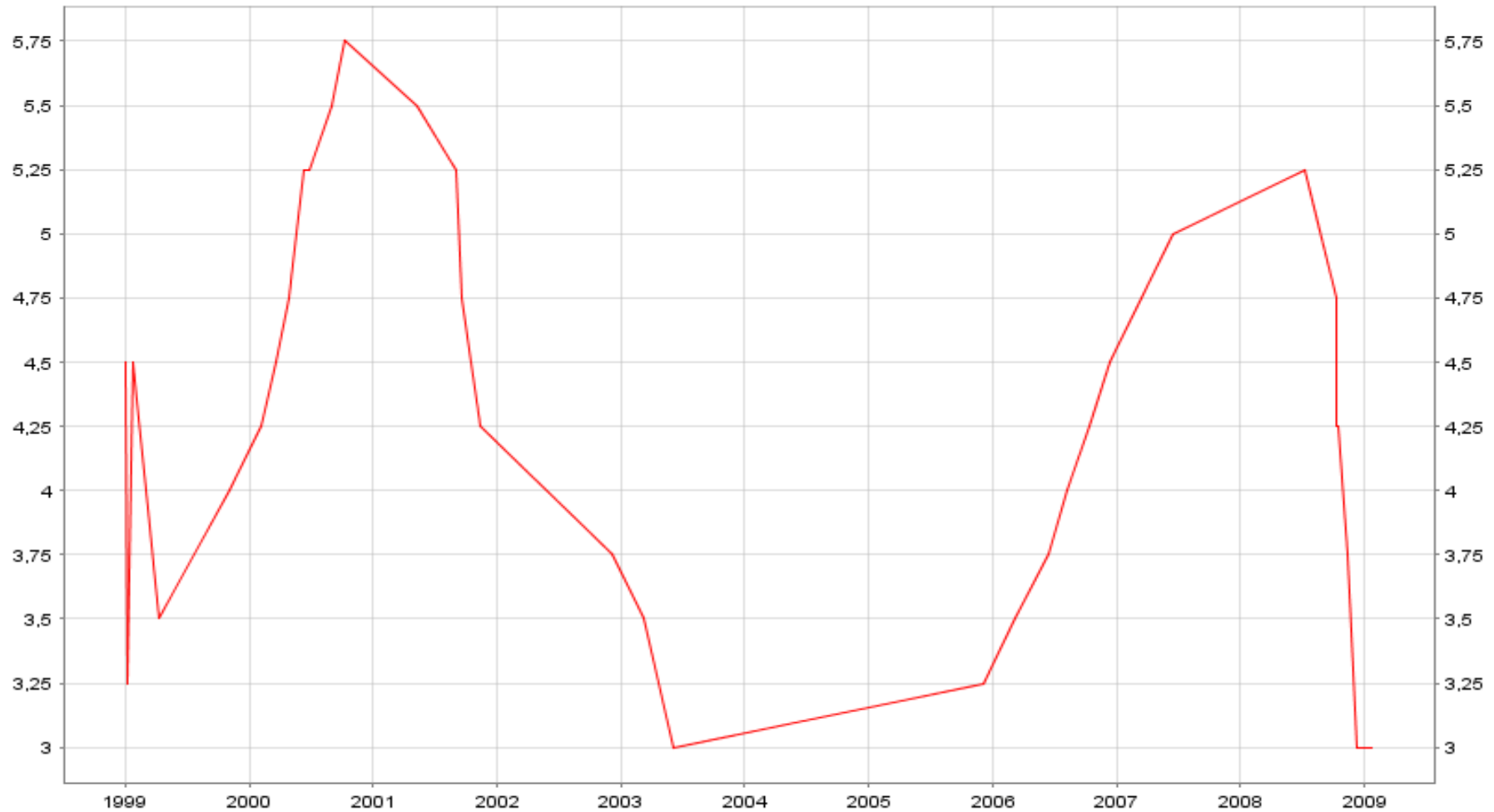


Anti-crisis measures in the Eurozone

- The first phase (until LB) – mostly ignoring crisis
- Then focus on rehabilitation of banking sector
- ECB – first tightening then easing (at rather moderate pace); more focus on quantitative measures
- Limited fiscal stimulus (borrowing constraints of some EMU members)
- Is a coordination on EU level sufficient?



ECB marginal lending facility



FM.B.U2.EUR.4F.KR.MLFR.LEV (Percent per annum)

Policy responses – at core

- Monetary policy: quantitative easing in order to avoid further collapse in global liquidity (many practical dilemmas such as how far to go, when to start withdrawing money stimulus, central bank balance sheets)
- Systematic and market-friendly rehabilitation of financial sector
- Careful approach to discretionary fiscal stimulus (other than costs of financial sector rehabilitation)
 - Inter-temporal fiscal constraints
 - Political difficulty to withdraw
 - Crowding out effect for emerging markets
 - Protectionist danger



Policy responses – at periphery

- Monetary policy: depends on monetary regime and individual country conditions but generally no room for aggressive easing and sterilization of capital outflow (danger of speculative attack)
- Market-friendly rehabilitation of financial sector (where necessary)
- Very limited room for anti-cyclical fiscal policy (borrowing constraints) – apart from countries which have accumulated sovereign funds



Policy responses – general recommendations

- Avoid protectionist measures
- Nationalization limited to banks only (when other sources of bank recapitalization are not available), on temporary basis, without nationalist bias and with clear exit strategy
- Return to structural reforms (e.g. labor market flexibility, limiting unfunded public liabilities, etc.)
- Overhaul of financial supervision on national level and creating supra-national financial supervision (especially within the EU)
- More global macropolicy coordination (the role of IMF?)



Challenges for economic research/ analysis

- Shift from short- to long-term perspective
- More attention to interlinks between micro and macro (e.g. interlinks between financial sector regulations and monetary policy)
- Reassessing DIT and other monetary regimes
- More focus on global perspective and cross-country dependence
- Lack of theoretical models and analytical frameworks allowing to analyze global economy

