Understanding Financial Crisis of 2007-08

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The article 'Ten years on, in uncharted waters' appears in The Hindu for 19th September, *2018. It traces the reasons behind the financial crisis of 2007 and highlights the lessons that can be drawn from it.*

The interconnectedness and interdependence of economies in the age of financial globalisation come with their set of merits and demerits. Both strength and vulnerabilities are at play at the same time. Financial crises that emerge in such conditions require better analysis and understanding so that future risks that accompany the growing financial connectivity of the economies around the world can be averted.

The bankruptcy of Lehman Brothers
On 15 September 2008 when the US government allowed the investment bank Lehman Brothers to go bankrupt.
When Lehman Brothers went down, the notion that all banks were "too big to fail" no longer held true, with the result that every bank was deemed to be risky. Within a month, the threat of a domino effect through the global financial system forced western governments to inject vast sums of capital into their banks to prevent them *collapsing. Credit flows to the private sector were choked off at the same time as consumer and business confidence collapsed. All this came after a period when high oil prices had persuaded central banks that the priority was to keep interest rates high as a bulwark against inflation rather than to cut them in anticipation of the financial crisis spreading to the real economy.*

Understanding the 2007-08 Financial Crisis: Causes

The massive flow of savings from the surplus countries to the deficit countries lowered global interest rates by encouraging reckless investment into risky housing-related assets such as subprime mortgages. These macroeconomic imbalances affected the financial interactions. Apart from this, loose monetary policy in the U.S left the banks with a decrease in net interest margins for the banks, decreasing their profits. The bloated financial sector, flawed belief in efficient markets, greedy bankers, incompetent rating

agencies are considered to be some of the other causes for the financial crisis.
However, failure of regulation on the banks' parts was one of the major reasons behind the crisis. Banks were allowed extraordinarily high levels of debt in relation to equity capital. Also, investment by banks in the advanced economies in complex assets called "securitised" assets (securities derived from sub-prime loans or the housing loans of relatively higher risk) added to the vulnerability of the financial infrastructure. When debt defaults increased with interest rates while income growth remained subdued, the world became more vulnerable to financial crisis.
Banks' dependence on short-term, riskier loans was not just an American problem but a problem for large chunks of the global banking system. Banks in Europe and some in Asia were affected as well. Further, the failure of banking systems around the world was aggravated by the by fiscal and monetary expansion. The loss of jobs and output has been enormous.

The Problem of Regulatory Capture

The ability of financial institutions to influence policies of governments and regulators also known as 'regulatory capture' was experienced after the breakdown of the global financial system. Financial institutions are a big source of political funding. Various political consequences were observed in the wake of the crisis. Many European countries like Greece, Spain, Portugal were found to be loaded with government debt that they were unable to refinance (the Eurozone crisis). The United Kingdom withdrew from the European Union (Brexit). The U.S. observed the rise of nationalism and anti-immigrant policies along with the return of protectionism.

India and the Crisis

India did not suffer much on account of the financial crisis. Absence of full capital account convertibility, a strict check on short-term foreign borrowings and its relative disconnect with the foreign banks insulated it from the devastation that was faced by the global financial system at that time.

Capital account convertibility: Capital controls are used by the state to protect the economy from potential shocks caused by unpredictable capital flows. Capital account convertibility means the freedom to convert a currency for capital transactions and the rupee is not fully convertible on that front yet, though capital flows have been liberalised in recent years.
Capital Account Convertibility is not just the currency convertibility freedom, but more than that, it involves the freedom to invest in financial assets of other countries.

Way Forward: Lessons Learnt and Issues Yet to be Addressed

- Increasing the equity capital of the banks and reducing their dependence on short-term loans were the steps that were taken post-crisis. The measures have made banks safer than before the crisis, however, a lot needs to be done.
- Financial sectors of emerging market economies now have more and deeper links with international financial markets, also reflected in high foreign ownership of stocks and government bonds, with large sudden capital outflows causing financial crises. Measures to make the system safer and more resilient must be supplemented by a workable set of crisis intervention tools.
- The provision of emergency liquidity to the banking system remains a core function of central banks. Such stabilisation efforts can help avert broader turmoil and buy time to address the underlying problems.
- Some of the biggest banks in the world have grown even bigger after the crisis. Concentration in banking has increased. The ‘too big to fail problem’ (some banks being so large that they cannot be allowed to fail) needs focused analysis and resolution.
- A crucial aspect of the financial crisis was the build-up of private debt, that is, the debt of households and non-financial firms. The key driver of the recession in the U.S. was the rise in household debt and the consequent drop in household consumption. The growth in credit as well as the flow of credit into sectors such as real estate needs strict regulation.
- The international rules that standard-setters such as the Basel Committee on Banking Supervision have already agreed must be consistently implemented across jurisdictions and their effects should be carefully monitored by both regulators and industry. Authorities should aim to establish trust and institutionalised co-operation, limiting the need for unduly burdensome local capital and liquidity requirements of the countries.

The collapse of the Bretton Woods system in 1971 witnessed the emergence of the US dollar as the main international reserve currency in the world. The dependence on the dollar needs to be reduced in the times of deepening financial globalisation, as it will continue to significantly affect the vulnerable emerging markets, as observed in the present conditions.