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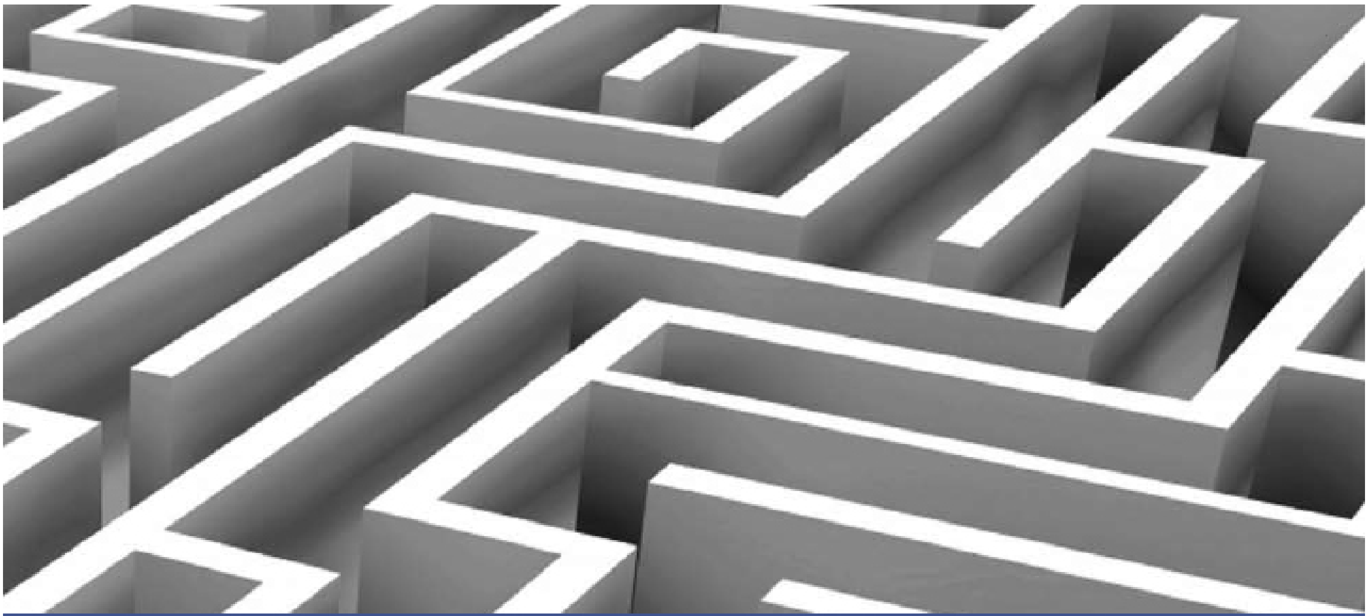
Pubblicato il 24/9/2009



THE FINANCIAL CRISIS: UNDERSTANDING IT TO OVERCOME IT

Marcello Messori

ASSOGESTIONI
associazione del risparmio gestito

Developments in the international banking sector in the first decade of the twenty-first century were dominated by the financial crisis that erupted in the subprime mortgage market in United States in mid-2007 and is still under way (as of May 2009). This crisis, which swept first through the investment banks and large complex financial groups of the economically advanced countries but then hit the global economy, is not an isolated financial episode. In the mid-1990s there was the Mexican crisis. Two years later a severe crisis was triggered in East Asia by the reallocation of capital flows; it spread to Russia, Argentina and Turkey at the turn of the century. As the new century got under way the leading international stock markets were rocked by the bursting of the so-called new economy bubble and by a spate of corporate scandals that also involved many banks; in Italy, the most notable instances were the Cirio and Parmalat bankruptcies, which cost small investors dearly, undermined the reputation of large Italian and foreign banks and exposed severe faults in the effectiveness of auditing firms and rating agencies.

It is possible that the financial crises of the last ten years have common origins, and in the case of the current crisis the consensus view is that it is due mainly to international macroeconomic imbalances, a regulatory deficit and the overly expansionary monetary policy stance adopted in the United States from the second half of the 1990s onward to buffer the impact of these crises on the US equity and debt markets. Nevertheless, historical analysis shows that each financial crisis is significant for its specific features, and that the current crisis - the gravest in the last seventy-five years - will bring about far-reaching changes in the organization and regulation of the banking sector and of the whole economic system. Hence the aim of this essay is neither to analyze all the determinants of the global turmoil nor to offer theoretical models of the financial and banking crises and of their possible regulatory solutions (see Allen and Gale 2007; Rochet 2008). The less ambitious attempt is to outline the different phases of the current financial crisis and to assess the short-term policy interventions and the long-term reforms that could help overcoming it.

Between 2001 and 2005 the global economy enjoyed abundant liquidity and very low, sometimes even negative real interest rates. Together with the progressive integration of international markets and the diffusion of an epochmaking technological innovation (information and communication technology) well beyond the United States, these conditions stimulated worldwide investment and enabled Brazil, China, India and other developing countries to achieve very high rates of growth and others to enter the international spotlight. During the period the world economy expanded rapidly and inflation held at low levels in the developed countries. But these macroeconomic conditions were accompanied by mounting international disequilibria: growing balance-of-trade and public and private sector deficits, above all in the United States, compensated for by capital transfers from developing countries with large trade surpluses. In the United States (but also in some European countries), the resulting relaxation of budget constraints further stimulated borrowing by household to finance the purchase of durable consumer goods and, especially, houses, creating a spiral between rising house prices, rising value of loan collateral and easier mortgage lending.

The three largest countries of the European Monetary Union (Germany, Italy and France, most notably the first two) remained somewhat on the sidelines of these developments owing to their difficulty in adapting to the international markets' new operating set-up, their high propensity to export and the more moderate monetary policy of the European Central Bank.

In the same period the international banking sector, with the partial exception of German banks, underwent profound transformation. It was exposed to more competition in traditional banking business but also introduced major financial innovations, reaping large profits. Meanwhile, it continued to pursue the process of consolidation that had begun in the 1980s in the United States and spread during the 1990s in Europe. Consolidation did not only involve mergers between commercial banks (specializing in traditional retail or corporate activities), but also acquisitions by commercial banks of investment banks or non-bank intermediaries. Consequently, even in the United States, the

United Kingdom and other countries without a tradition of universal banks, commercial banks progressively expanded the range of financial services they offered to include high-value-added activities of the kind that once typified other financial intermediaries. These banks thus became large complex financial groups. In the present decade this trend gained pace and also gave rise to new specialized banks as a response to the diminished centrality and profitability of traditional credit activities. Legislative and regulatory change either accompanied these market changes (Europe) or certified them (the United States); especially in the US, the regulatory structure failed to grasp their nature and to control their course. In the renewed international banking sector, the introduction of information and communication technology went hand in hand with continual financial product innovation. Thanks partly to the abundance of liquidity and low real interest rates, opaque, high-yielding new financial instruments gained ground and conjured up market segments that were regulated lightly if at all and often characterized by low transaction volumes ("thin" markets).

As early as the 1980s, a "financialization" of traditional bank loans had begun with the changeover from the "originate-to-hold" model, where loans were carried on banks' books to maturity or until renegotiation, to the "originate-to-distribute" model, based on the securitization of (a portion of) bank loans and their transformation into tradable assets. In the last decade the changes described above led to the dominance of the originate-to-distribute model but also to a degeneration of its key features. The drastic rise in subprime mortgage lending in the United States and the consequent increase in default rates, which in June 2007 touched off the banking crisis and caused it to spread rapidly from the US mortgage market and embroil many financial intermediaries in all the developed regions of the world, are the outcome of that degeneration.

This essay is divided into four chapters. The first three analyze the five phases of the current crisis. The fourth deals with longer-term problems relating to the designing of new rules that can respond to the ever increasing pace of financial innovation.

The first chapter aims primarily at supporting the argument that the current financial crisis was sparked, among other causes, by the degeneration of the originate-to-distribute model (Section I.1). It draws the perimeter of the first two phases of the crisis, which were characterized by the severity of the problems that emerged in the last quarter of 2007 in the banking sector (Section I.2) and the inability of regulatory authorities and economic policymakers, notably in the United States, to grasp what was new in these developments and to prevent the resulting financial market "failures" (Section I.3). The second chapter analyzes the third and fourth phases of the crisis. The discussion of the events that marked the last four months of 2008 shows that the short-term monetary operations intended to mitigate liquidity hoarding and deleveraging, and ad hoc government measures to avoid systemic banking failure, necessary as they were, were nonetheless not sufficient to attenuate the financial crisis and buffer its recessionary impact on the world economy. Starting in September 2008, the "failures" of regulation and of discretionary State action led to the launching of more complex plans in all the main economic areas (Sections II.1 and II.2). Yet these plans, too, did not produce the hoped-for results (Section II.3).

The third chapter stresses that some progress was seen only after the temptation of returning to the past had been overcome and the different policy alternatives weighed (Section III.1). Hence, in March and April 2009 more complex measures were taken (Section III.2). Leaving aside the anomalies of the Italian case (Section III.3.), the aim of these measures is to restore more orderly market conditions and revive confidence among operators; however, except in some minor respects, these measures do not constitute new rules of the kind needed to lessen the likelihood that the current crisis "can happen again" (to echo the question raised by Minsky (1982) referring to the crisis of 1929-33). Accordingly, the fourth chapter is given over to the measures needed in the medium term to shape the contours of a new regulatory framework. A discussion of the often problematic links between short-run and medium-term interventions (Section IV.1) is followed by an examination of the efforts made in the first five months of 2009 to design new regulatory and supervisory arrangements at international level and within the two leading economic areas (Section IV.2). Even if these arrangements were put in place, various problems and many opportunities would still remain open (Section IV.3). Hence the Conclusion offers additional suggestions to overcome the current financial crisis and, in the meantime, to lessen the likelihood of “it can happen again”.

Il paper di Messori ripercorre le fasi che hanno portato alla peggiore recessione degli ultimi 75 anni, a partire dai problemi emersi nel settore bancario statunitense a fine 2007, fino all’estendersi degli effetti della crisi alle altre economie mondiali

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