The US Financial Crisis: Comparisons and Lessons

Ramkishen S. Rajan
Associate Professor
School of Public Policy
George Mason University, VA
E-mail: rrajan1@gmu.edu

The world witnessed a series of destructive financial crises from the mid 1990s until 2001 - Recall Mexico and the Peso crisis in 1994-95, the Asian crisis in 1997-98, Russia and LTCM in 1998, Brazil in 1999, Argentina and Turkey in 2001, and so on. Not surprisingly, international capital flows that reached a trough in 2001-02 picked up sharply from then on as calm seemed to have returned to the global economy. Yet there were strong, lingering concerns about when and where the next financial crisis might hit.

Few observers, however, would have predicted the US would be the next victim. To be sure, there were concerns about the size of its twin deficits and the possibility of a housing bust and the consequent recession, but it would be fair to say that not too many would have anticipated an outright financial crisis in the US.

This said, there some key differences between the typical crisis that has thus far hit emerging economies and the one which has afflicted the US. In the typical crisis in an emerging economy, there is usually some shock such as an actual or possible bankruptcy of a major corporate or financial institution, political disruption, or even externally-induced shocks, eg, contagion from neigbouring economies. This causes a rise in risk premium and a consequent withdrawal of capital from the country, which in turn is the true beginning of the crisis.

Many a time a full-fledged currency crisis could have been averted if the country had, via a combination of policies, aimed at calming a jittery market, raising interest rates, and a currency depreciation (e.g. Indonesia in 2005). The real problem arises when the central bank attempts to dogmatically defend the currency through sterilized foreign exchange intervention. In essence, this involves the central bank standing ready to buy its currency coming under significant selling pressure. On its own, this action would effectively be a contractionary monetary policy as it would involve a draining of liquidity. However, more often than not the intervention in the currency markets is supplemented with a rather massive infusion of liquidity into the domestic banking system which is faced with a liquidity crisis.

It is not surprising, therefore, that during the Asian crisis of 1997-98, money supply in many of the crisis-hit economies expanded sharply (especially in Indonesia and Thailand). Central banks were essentially sterilizing their foreign exchange intervention to bail out the domestic financial institutions. As capital keeps fleeing the country, at some stage the central bank loses all of its reserves (as in Thailand) or decides that such a policy is a losing battle and stops doing so (as in the case of Indonesia). Since the central bank is no longer propping up the domestic currency, there will be a sharp devaluation.

In a few situations the devaluation turns out to be the end of the crisis (eg. Brazil in 1999-2000) as it boosts export competitiveness, which in turn leads to resumption in domestic growth and return in confidence in the economy as international capital starts to flow back in. In many other cases, however, (eg. Mexico, Thailand, Indonesia, etc), the financial-cum currency crisis turns into a full fledged economic crisis as the devaluation leads to corporate and financial sector bankruptcies and massive dislocations.

A plunging currency, rapidly deteriorating balance-sheets, severe financial market turbulence and massive credit crunch -- the crisis in the US looks quite similar to that which has plagued many other emerging economies. However, there are some key differences. The crisis in the US has predominantly been a domestic one, i.e. the mortgage meltdown has led to a worsening of balance sheets of many institutions and a tightening of credit availability and heightening credit spreads. In order to avoid complete paralysis in the US credit markets, the Fed has been sharply lowering the Fed funds and discount rates, as well as flooding the market with liquidity via newly-established credit facilities, including the Primary Dealer Credit Facility (PDCF), the Term Auction Facility (TAF) and the Term Securities Lending Facilities (TSLF) and the (hopefully) one-off intervention in the case of Bear Stearns.

The important point is that the crisis has not been driven by a reversal in international capital flows. Thus, while the US dollar has been declining, it has been largely due to the downward trend in risk-free interest rates in the US as opposed to an outright currency run that one often witnesses in many emerging economies. Foreigner investors by and large do not appear to be demanding a greater premium to hold US denominated risk-free assets (witness U.S. bond yields).

Notwithstanding the Treasury's oft-noted "strong dollar" policy, the government has been quite happy to see the greenback decline as it has given a boost to short tem price competitiveness of US exports which in turn has been the sole engine of growth, helping - at least partly - to offset the weak domestic demand. The economists, Carmen Reinhart and Kenneth Rogoff have noted that in other domestic financial crises, the decline in real per capita output growth has averaged over 2 percent, and it can take two years to revert to trend. This is not an unreasonable expectation for growth dynamics in the US in the near future. If this is the case, demand from Asia and the rest of the world needs to help prop up the global economy in the next few years as the US gets itself out of the self-inflicted subprime-induced financial debacle.

Regardless of how the US crisis is finally resolved, the US financial debacle has highlighted many questions issues that policymakers in emerging economies need to pay particular attention to and grapple with when it comes to their financial sectors. We consider two below.

First, is there an inevitable tradeoff between financial deregulation and instability? While many emerging economies have been liberalizing their financial sectors as a means of promoting efficiencies and product innovations, it is clear that this sector is a different animal altogether from other sectors like manufacturing. While disruptions in a manufacturing firm – even a very large one – will lead to some inevitable disruptions to employees in that firm as well as in ancillary firms, by and large these will be limited in scope and scale. This is unlike the financial sector where disruptions in even medium-sized institutions could lead to a chain reaction of defaults and have marked repercussions on the rest of the economy. While there is no doubt that well-functioning and liquid financial markets are critical for overall economic growth, there are ample reasons to believe that markets cannot price risk appropriately.

Given the need for the central bank to possibly "bail out" the financial system in times of stress, a government clearly cannot adopt a laissez faire attitude towards this sector. Indeed, in October 2002, Ben Bernanke himself in a speech in New York noted the importance of "supervisory action to ensure capital adequacy in the banking system, stress testing of portfolios, increased transparency in accounting and disclosure practices, improved financial literacy, greater care in the process of financial liberalization, and a willingness to play the role of lender of last resort when needed."

Second, should financial sector regulations by partial or comprehensive? By and large, the US commercial banking system has been tightly regulated, with the Fed standing ready to assist them via the discount window in times of stress as a means of reassuring the public. This is so because a typical household depends on the commercial banking system as a financial intermediary and expects that their savings placed in such institutions are relatively safe. Even a whiff of concern could lead to a bank run and outright panic. As against this, investment banks have been allowed a relatively free hand, and it is not surprising therefore that they have generally been highly profitable institutions. Depositors, equity and bond holders in such institutions are looking for greater returns and presumably therefore willing to take greater risks. The implicit assumption has been that these and other non-commercial banking institutions would not be "bailed out" by the Fed. Indeed, until recently these investment banks (primary dealers) were excluded from borrowing directly from the Fed, though this has changed recently (with changes to discount window and creation of other lending facilities).

The Bear Sterns debacle, which could have threatened to shut down a significant part of the US financial system (due to the heavy leverage of that bank as well as because of ripple effects via rising risk premiums), has emphasized that financial regulation cannot be partial as it offers scope for regulatory arbitrage, especially if there is an expectation going forward that the Fed will act as a backstop for financing, at least partially, in order to prevent the extent of collateral damage to the financial system.

Going forward, it is paramount that policy makers in India, Asia and elsewhere learn the right lessons from the financial debacle in the US if they are to obviate such problems in the future. At the minimum, regulatory structures will need to be reviewed; it just cannot be 'business as usual'.