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Global financial crisis: Exploring its origins and formulating preventive measures

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Abstract

This paper offers a comprehensive analysis of the 2008 crisis, dissecting factors such as global imbalances, housing bubbles, innovation, and leverage. It underscores the need for effective risk management and regulatory reform to avert future crises. Emphasizing the regulatory trilemma—balancing stability, efficiency, and uniformity—the paper advocates for a flexible and collaborative approach among regulators, financial institutions, and stakeholders. By continuously reassessing strategies and fostering adaptability, the paper aims to create a resilient global financial ecosystem capable of preventing and mitigating future crises.

Keywords: Imbalances, housing bubbles, innovation

Introduction

As technology advances and there is an increase in globalization, financial markets around the world are becoming more and more connected. Resultantly, there has been a steady increase in international trading and it is ever easier to grow business internationally. With this rise in international trade and business, global finance has become an essential topic of understanding for individuals, the corporate world, and especially governments worldwide. Global finance can be in the simplest terms defined as financial activities and in addendum markets that occur on a worldwide scale daily. It is a framework of economics, regulations, and financial institutions and they interact with each other. This includes many topics such as exchange rates, trading, cross-border transactions, investments, and the movement of capital among governments. It is an ever-changing field and requires an in-depth study to understand its nuances.

Global Financial Crisis (GFC) is defined as the period between mid-2007 and early 2009, during which a fall in the US market was a catalyst for a financial crisis that spread from the US to the rest of the world through the Global Financial System. Huge losses were incurred by banks worldwide while the government supported many of them to avoid potential bankruptcy. Thousands if not millions of people lost their jobs as the major advanced economies experienced their deepest recessions since the Great Depression in the 1930s. Historically, it has taken eight years to recover from any debt crisis, and the same is held in this case as well.

What went wrong?

The reform strategy must effectively tackle the pervasive opacity within both the economy and governance. In addition, there exist three supplementary categories of factors that have garnered insufficient scrutiny from regulators and financial authorities, potentially exacerbating risks. Firstly, the persisting global macroeconomic imbalances spanning the previous decade have contributed to a reduction in interest rates, consequently elevating risk levels and diminishing the valuation of global assets. Secondly, the transformations witnessed in the financial market's structure during the past two decades, coupled with an inadequate alignment of risk management with these financial shifts, have rendered the system functional but volatile in its impact. Thirdly, leveraged financial entities possess a propensity to undertake excessive risk in the absence of tangible consequences, thereby necessitating regulatory oversight as a primary countermeasure.

Global imbalances and housing bubbles

Regulators and crucial banks failed to safely well-known and address the systemic risks

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connected to fast credit score increase and asset price bubbles. At some stage in this decade, some economies ran chronic big current account surpluses, which generated a large call for monetary belongings issued in deficit nations—substantially for U.S. property. This, collectively with an accommodative U.S. monetary coverage, contributed to low actual interest rates worldwide, which in flip induced great risk-taking and fed rapid credit increase. Inside the U.S.A., the credit market debt of households and nonfinancial organizations grew from 118 to 173 percent of

GDP between 1994 and 2007 (see chart). The boom of the credit score debt of households expanded even extra considering 2000, leaping in seven years from 98 to 136 percent of disposable private income. At some point of the same duration, comparable ratios grew from about 120 to 180 percent within the United Kingdom and from 72 to 91 percent in the Euro region. Simultaneously, an unparalleled surge in home prices occurred in the United States, mirrored by comparable booms in numerous other developed economies.

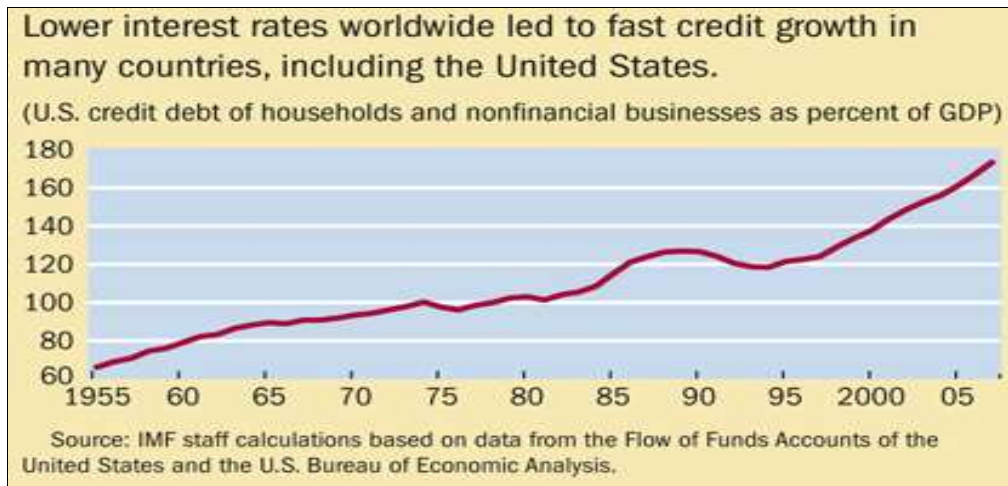


Fig 1: Soaring debt

Innovation and structural changes

In their April 2008 assessment of the underlying factors behind the contemporary crisis, both the IMF and the Financial Stability Board (FSB) underscored the conspicuous deficiencies in risk management practices. Moreover, they highlighted the collective oversight in assessing and addressing the extent of leverage—represented by the debt-to-equity ratio—undertaken by a broad spectrum of institutions, along with the associated perils of an uncontrolled unwinding. The domains of risk management, disclosure, regulation, and supervision were unable to keep pace with rapid innovation, thereby permitting room for excessive risk-taking and the inflation of asset prices.

Destabilizing incentives

The stuff that went down suggests that a few regulators put way too much faith in financial outfits' knack for juggling risk and sorting themselves out. At the same time, they turned a blind eye to the dwindling safety net of capital reserves due to fancy financial tricks like securitization and shady off-the-books maneuvers. Oh, and those half-baked risk reduction strategies (like credit default swaps from places without enough backup cash or capital), well, those didn't exactly help either. Regulators might have been better off acknowledging and tackling the strong allure that high-stakes gambling holds for these leveraged financial groups, without factoring in the possibility of the entire system going haywire. They could've done this by rolling up their sleeves and making use of their supervisory powers and being tougher when it came to enforcement.

Leverage and risk

Shareholders and bigwigs at high-risk financial outfits are

enticed to pump up immediate profits by embracing excessive long-term uncertainties—leveraging their grip on information imbalances to shift these risks onto the future or unsuspecting players in the market. Specifically, their impetus revolves around juicing up short-term equity gains via a leverage spree, even if this spikes the odds of default. This all happens as long as lenders don't tag this danger onto the debt's price (perhaps due to safety nets like deposit insurance or a lack of transparency), and as long as the honchos' brush with downside risks remains minimal (Rajan, 2005) ^[6].

Disregard of systemic risk

Looking back at previous financial meltdowns, it's pretty clear that economic institutions haven't exactly been champions at taking responsibility for the whole system crashing down. Here are some real-life instances of what can go wrong when a bunch of financial players start following the same reckless playbook:

- They crank up their borrowing power when things are going well, not even thinking about how it might inflate a humongous bubble that's bound to burst sooner or later.
- Instead of holding onto stable resources, they start playing with risky short-term funds and backup plans that can vanish into thin air as soon as things get rocky.
- They go overboard with giving out loans to specific sectors, even when interest rates are unreasonably low, conveniently ignoring the ticking time bomb in their mortgage portfolios when rates eventually bounce back and slam heavily-leveraged borrowers.

As if that's not enough, these financial players and their higher-ups are also all gung-ho about following the herd, amping up the danger factor in unison. Why? Because they're either competing like mad to stay on top in the

market, or their fat paychecks are directly tied to how their performance measures up to the rest, or they've just got it in their heads that if everything goes to hell, the losses will somehow magically be shared by everyone.

How can we avoid crises in the future?

Back in 2017, when Mark Carney was still calling the shots at the Bank of England and helming the Economic Stability Board, he dropped this gem: "G20 financial reforms have patched up the cracks that triggered the big financial crisis over the last decade" (Carney 2017) [1]. He was essentially saying that the rules and regulations enacted since 2008 had done their job, toughening up the financial realm against the menace of a full-blown system-wide meltdown.

In his book, "The Illusion of Control", Danielsson argues the complete opposite. Despite the costly and grueling hoops that regulations make financial players jump through, he contends that we're now sitting on a powder keg of systemic financial doom, more precarious than ever. You see, while these rules have made us masters at tackling the ups and downs driven by external factors in today's risk landscape, they've sort of thrown us off the scent of the internal hazards brewing within the system that could blow up into a full-blown catastrophe. The result? A false sense of security that's got us all thinking we're in control when, in reality, it's just a grand illusion.

Financial laws are put in the region to help us to manage the trade-off between protection and growth. Therefore, the number one goal of regulation is to maximize financial boom in a regulatory regime designed to correctly shield the folks who use the gadget (micro-prudential law), and that doesn't supply upward thrust to too many crises (macro-prudential law). A regulator might be tasked with other goals too that have little to do with increase—for instance, the safety of the environment. But encouraging financial

increase will continually be a regulatory goal.

However notice that the objective of regulation isn't to de-threat the financial system, nor to obtain financial stability, nor to make sure compliance. The ones are the contraptions hired with the aid of a regulator.

Perceived risk and economic activity

Empirical evidence attests to the significance of market sentiment in approximating the degree of risk exposure inherent in financial activities. When financial markets register a heightened perception of risk within a given year, it tends to translate into a reduction in capital flows and investment, thereby impeding economic growth for that year and the subsequent one. Conversely, a low-risk perception corresponds to an upsurge in capital flows and investment, fostering economic expansion for the current year and the subsequent one. However, a notable exception arises when a prolonged period of excessive credit growth prevails, potentially altering the anticipated outcome.

It is important to note that the dynamics may take a different turn after a span of two years. Specifically, the momentum generated by the surge in capital flows and investment due to low-risk perceptions could reverse, resulting in a subsequent deceleration. Nonetheless, it is noteworthy that, within this context, the overall impact remains affirmative, except when an unchecked expansion of credit has significantly skewed the landscape.

However how are those perceptions of threat formed, and what do they represent? Figure A indicates a hypothetical illustration of financial market outcomes (red curve), in which risk is the lower tail, and the regulator's desired policy outcome (blue curve). The excellent strategy for the control problem reduces the likelihood of terrible effects—a thinner lower tail—and will increase the likelihood of correct outcomes.

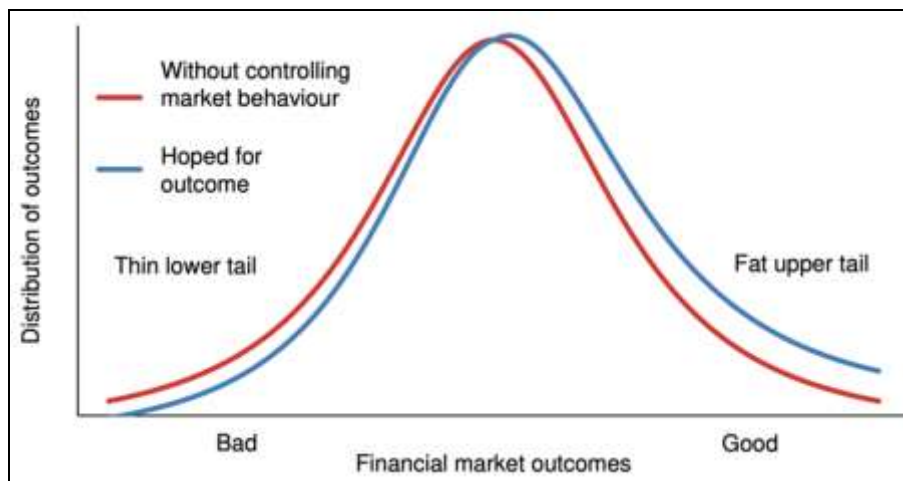


Fig 1: Desired policy outcome for a financial regulator

Risk in perception and reality

Regulators and risk managers within the private sector not only hold differing perspectives on achieving this objective but frequently characterize the issue in contrasting manners. Regulators commonly attribute the irresponsible pursuit of high yields by private investors as the root cause, whereas these investors often perceive regulators as excessively fixated on surface-level indicators of risk.

Whom do we believe? Where we pin the blame for a crisis depends on how we measure the amount of risk in the

system. Directly perceiving risk is unfeasible, prompting us to rely on estimations derived from historical data encompassing prices and events. Diverse models for quantifying risk exist, yet their disparities persist, lacking a priori means to ascertain the utmost precision among them. Yet we persist in the belief that actors in the market all have access to a single risk meter, a mythical device that can capture the true level of risk in the system and express it as a precise number.

Attempting to devise a precise risk gauge proves to be a fruitless endeavor. Even when a risk assessment incorporates historical data that pertains to frequency, it grapples with the challenge of predominantly aligning the data with the central portion of the curve (as depicted in Figure B), rather than the tails that hold our interest. Consequently, any projection of tail risk unavoidably hinges

on the inclinations of the model's creator, thereby urging caution in employing such projections to predict systemic risk levels with a high degree of certainty, despite the potential for enhanced accuracy. While technically feasible, this endeavor lacks substantive value and might engender a deceptive sense of confidence in the precision of the measurement.

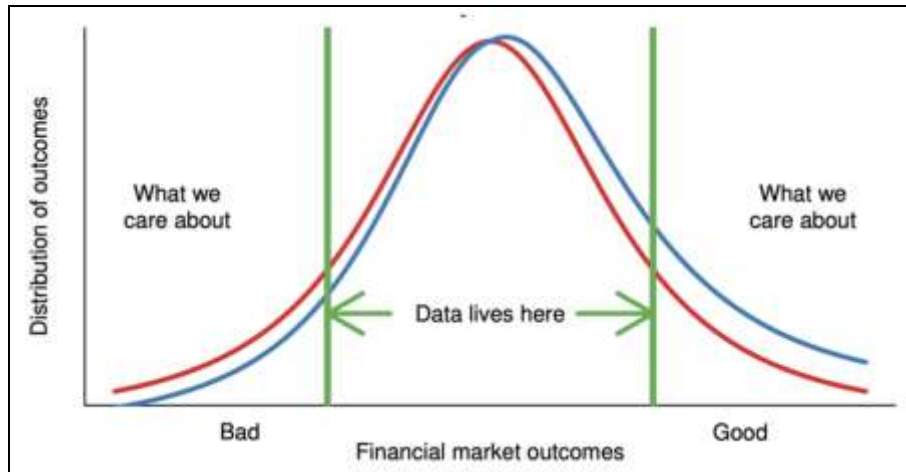


Fig 2: Available data on financial market outcomes

Also, different crises like 2008 and Covid-19 have different drivers and require different responses. Crises happened in different places at different times, so it's hard to learn much from history. Laeven and Valencia (2012)^[4] found that the typical OECD country suffers a systemic crisis only once in forty-three years, making it rather difficult to train the risk models.

The accumulation of risk in the system may take years or decades of apparent calm. This calm may help create

systematic risks. In the words of Hyman Minsky (1986)^[3], “Stability is destabilizing once the system has pooled risk, models used by private investors may show a risk assessment that is not related to actual risk. Figure C shows an example: a hypothetical price bubble. Steadily rising prices (blue) create a perception of risk (red) that misleads – the risk factor is the decreasing green curve when the price drops.

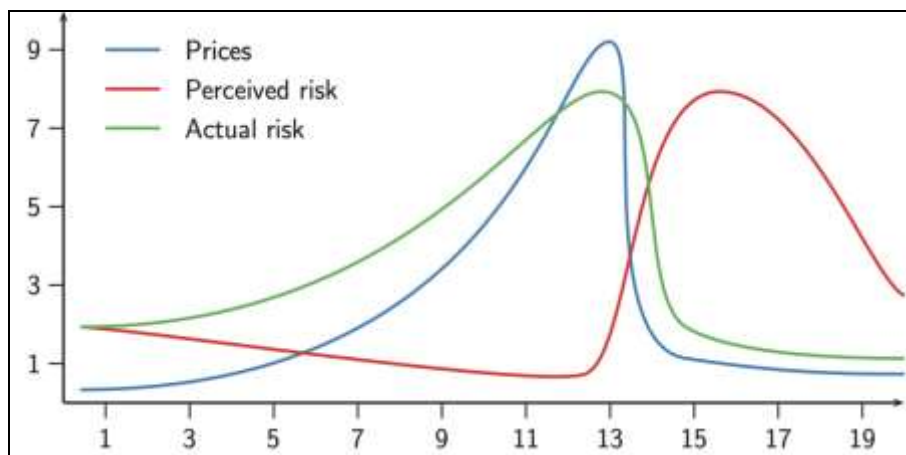


Fig 3: A price bubbles

The bank's risk prediction models consistently fall short in gauging the impending risk preceding a crisis (almost as if they're generating profits effortlessly) and subsequently exaggerate the risk post-crisis (Resulting in excessive price fluctuations). As a result, our model appears to be fundamentally flawed across all global jurisdictions.

The legal framework reacts to shifts occurring externally within the global landscape. However, the exogenous incidents that have unveiled risks in recent times—like the subprime financial crisis or Brexit—are inherently political in nature. This presents a challenge as unelected macro-

prudential regulators possess constrained legal and institutional mechanisms to effectively mitigate these risks. Market players trying to protect themselves can stir up internal uncertainty, eventually leading to a crisis. As they scramble to figure out and tackle recognized risks, regulators often slap on blanket rules like capital requirements and leverage limits. These rules boss around short-term moves by participants in reaction to events and policies. Meanwhile, all these actors are hustling to sync up with their goals (or personal leanings), hustling even harder to engage in exchanges that not only echo the starting signal

but also crank up its power.

Solving the control problem

Therefore, there is a trilemma in regulation (Figure D). Attaining complete stability, efficiency, and uniformity simultaneously is beyond reach.

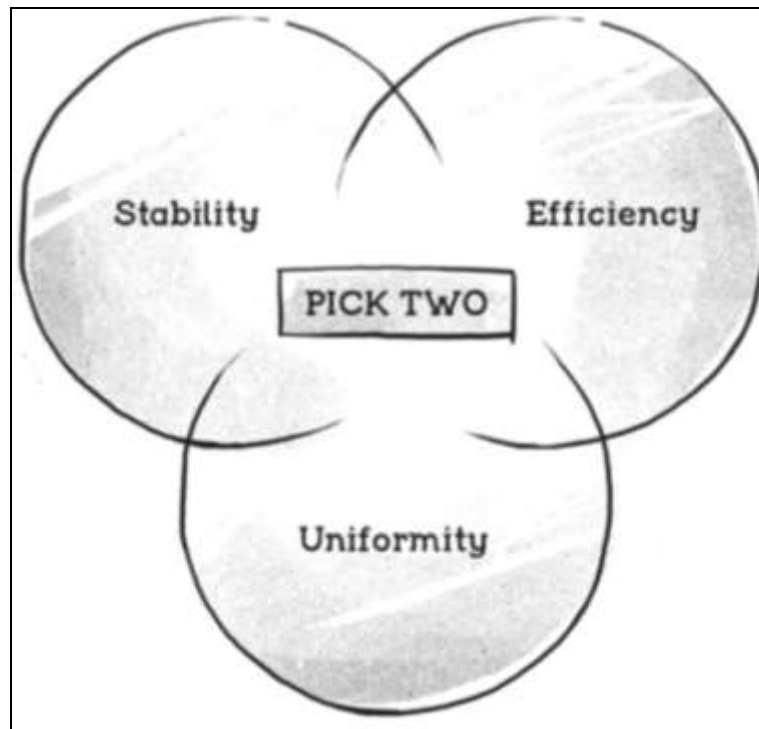


Fig 4: The regulation trilemma

A significant portion of regulatory authorities, including those operating after 2008, demonstrate a marked predilection for maintaining consistency. Their proclivity for standardized regulations revolves around fostering a level playing field and hinges upon the evaluation of outcomes stemming from external variables. Consequently, entities subject to regulation tend to exhibit analogous reactions in response to these events. This approach, however, encompasses only a limited segment of the overall purview, as it neglects internal dynamics - specifically, the inherent risk associated with the reactions of market participants.

Now imagine that we choose less uniformity in regulation and create more heterogeneous financial institutions that are free to choose different responses to these events. This action would enhance the system's ability to absorb shocks, consequently bolstering its capacity for automatic stabilization. To this end, management should abandon the notion of equal footing and reduce the requirements for new entrants to new business models in areas such as FinTech and DeFi.

This may be a hard sell to the risk-averse designers of regulation. It may also not be popular with workers who prefer the existing system – not least because the high fixed costs of being a part of the system keep them safe from new entrants. The alternative is to continue to create regulation that is not fit for purpose.

Conclusion

In conclusion, the ever-evolving landscape of global finance presents a myriad of challenges and complexities that demand careful consideration and nuanced approaches. As technology continues to reshape the boundaries of international trade and connectivity, the interdependence of

financial markets across the globe becomes increasingly pronounced. The global financial crisis of 2008 serves as a poignant reminder of the potential consequences of systemic vulnerabilities and the imperative of effective risk management.

The role of regulators in this intricate web of interconnectedness cannot be overstated. As they grapple with the task of balancing stability, efficiency, and uniformity, the trilemma of regulation emerges as a formidable challenge. The pursuit of standardized rules and uniformity may come at the cost of stifling innovation and adaptability, while a more heterogeneous regulatory landscape could enhance shock absorption but potentially introduce complexities.

The notion of risk perception further underscores the intricate dynamics at play. Market sentiment, often influenced by external events and factors, can drive economic activities and impact the overall health of financial systems. However, the limitations of risk assessment models and the inherent subjectivity of human judgment highlight the need for caution in placing undue reliance on these perceptions to forecast future trends.

Looking forward, a balanced and informed approach to regulatory frameworks is essential. Recognizing the limitations of one-size-fits-all solutions, regulators must adapt to the changing nature of global finance and encourage a more flexible regulatory environment that accommodates innovation without compromising stability. Collaboration between regulators, financial institutions, and stakeholders is paramount in ensuring a resilient financial ecosystem capable of withstanding future challenges.

In navigating the intricate tapestry of global finance, stakeholders must remain vigilant, continuously reassessing and refining strategies to address emerging risks. As Mark

Carney's contrasting viewpoints on post-crisis regulation suggest, the path forward may not be singular. It is in this spirit of ongoing inquiry, adaptation, and collaboration that the future of global finance finds its promise, offering the potential for sustainable growth, stability, and prosperity on a global scale.

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