



Global response to the financial crisis

Background to the 2007-9 financial crisis

William Brown

I think to start off with it would be a good idea if we painted a bit of background about the crisis in terms of how it arose and what the response to it has been. Hedley, can you start us off here?

Hedley

Yes, well there is quite a long history of liberalization in banking and the financial sector for at least thirty years now, in terms of removing, reshaping direct controls by the state on financial actors, the control of capital, movements of capital internationally, the activities of banks generally and more recently there is been a boom in credit across the major economies, fuelled in part at least, by very low interest rates. This became a particular problem in the United States in the housing market where mortgages were being granted to increasingly risky borrowers and these became known as sub prime mortgages. When this party really sort of got a little bit wild, it unleashed a chain reaction through the banking system because the debt which was incurred in these mortgages, didn't just stay with the – the original lenders, it transmitted itself throughout the banking and financial system, so there were bad debts spreading through the United States and Europe.

William

Okay I mean that's been an important feature of how the crisis has become more widespread, can you just explain the mechanism at worked there.

Hedley

Yes. Banks make mortgage loans to risky customers and they want to get rid of that risk so the loans are securitized that is to say the lenders package up the debt and sell it in the form of bonds to other financial institutions. Well that's fine while the system is working well because repayments made under those mortgage agreements can be then passed on to the holders of the bonds, but if the mortgage borrowers default the system starts to break down and obviously the holders of the – assets, the bonds, start not trusting the institutions that created those bonds. Well in this way the whole banking system can be infected, the banks don't know how much exposure other banks have to bad debts or toxic assets as they have come to be known. The banking system relies very much for its workings on inter bank lending, now when a bank is short of liquid assets, now for example at the Central bank, it will borrow short um er overnight for example from other banks – this lack of trust meant that that borrowing er dried up and so there was a banking crisis in the United States and Europe which then really became an economic crisis spreading much more widely than the United States and Europe.

William

Okay and the severity of both the financial sector problems and the economic crisis more generally has prompted quite unprecedented actions by governments. Simon can you summarise what some of the key responses from governments have been?

Simon

Yes we will come onto some of these in a bit more detail later on, but I think broadly they fall into two or three main categories. In the first instance there was intervention to sustain particular financial institutions and then as a kind of second stage to sustain the banking sector as a whole so that often involved er attempts by central banks to prop up their – the banks within the – within the states concerned, particularly in the United States and in the United Kingdom, which resulted in effect the nationalization of significant elements of the banking sector, that was one kind of immediate response and in a way er a response to the drying up of credit between banks that Hedley has talked about.

The second response by no means universal, but important in the United States most obviously has been a large fiscal stimulus, an attempt by the state to promote demand in the economy to off set contraction in other sectors of the economy. There has been a – stimulus in the United States but stimulus in other countries to a lesser extent, but also importantly in China. And then I think the third response is fairly limited thus far, but a – a degree of cooperation amongst states to as it were do no more damage, to agree amongst themselves that in responding to the crisis, they would not seek to take actions which might, while beneficial for an individual country, might damage the international stability of the world economy as a whole, so a kind of minimal level of cooperation to kind of do no harm as they tried to fix things.

William

And Grahame this cycle of financial crisis and government response is something that's a recurrent feature of the financial system in your view?

Grahame

I think its really worth just recalling that there have been financial crises before and many, many of them and er indeed one suspects that we will be – you know that it will happen again, there will be crises in the future perhaps and I suspect that will be the case. So there has been a kind of boom and bust sort of cycle in the financial system – several of these. This is probably a – an extreme example and I think behind this is a sort of dance or game between on the one hand the private financial sector, private financial institutions and the public sector that tries to regulate that – that private financial system and it's led I think very much by the innovations within the private financial system, producing the new products which Hedley was just mentioning – subprime mortgages in this case, the securitization of those and several other that were mentioned. When these um innovations happen in the cycle, there is always warnings about them, but these dangers I think tend to go unheeded, the crisis that is brought on by this hits the system, there is attempts to manage it in the manner in which Simon just raised and just said – that is where the collective action problem particularly comes into focus. This is followed by these periods of – of considering longer term changes to the regulation of the system to try to prevent it all happening again, only I think for the financial sector to have moved on in the meantime with a new set of financial innovations and it looks like the ones that are being introduced, the regulatory changes that are being introduced currently or to react to the previous crisis, look as though they are pointless because the whole system has moved on. Now we will come back to this in a moment, this kind of cycle, but I think its, this particular example has been extreme version of this, but there have been these cycles – many of them before and there will be again I suspect.