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# The international financial crisis: its nature and the economic policy challenges

*José Luis Machinea*

**T**his article discusses the origins of the international financial crisis, emphasizing the instability of the financial system as a leading cause. Although monetary policy in the early part of this decade may have helped to inflate the property bubble, it is far from having been the decisive factor. This article also argues that the function of controlling excessive asset price rises is one for regulatory policy rather than interest rates. What is proposed, accordingly, is the creation of institutional arrangements that facilitate the implementation of countercyclical financial policies during periods of strong economic growth. After considering the characteristics that economic policies in developed countries should adopt, the article then analyses the effects of the international crisis on the current accounts of the region's countries and the difficulty of applying countercyclical policies in the absence of a global lender.

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*"A sound banker, alas, is not one who foresees danger and avoids it, but one who, when he is ruined, is ruined in a conventional way along with his fellows, so that no one can really blame him."*

John M. Keynes (1931)

*"Most astonishingly, these now-doubtful techniques had previously been hailed as the cornerstones of modern risk management. Moreover, the turbulence proved greatest in countries whose supervision of credit risk had been thought to be the best in the world. Indeed, the regulatory standards and protocols of these countries were in the process of being emulated worldwide."*

Caprio, Demirgüç-Kunt and Kane (2008)

# I

## Introduction

As this article was being written, the world was still caught up in one of the worst economic crises of the past century. The epicentre was the financial collapse in the United States, but the shockwaves had spread to financial systems in parts of Europe. While the history of financial crises dates back several centuries (and the world has experienced some 300 of them, of differing sizes and characteristics, in the last 200 years), none has been as profound and far-reaching as the present one, with the sole exception of the crisis that began in the early 1930s.<sup>1</sup> Furthermore, economic policy responses being equal, this crisis is very likely to be far graver than that one. There are three factors suggesting this: the sheer size of the financial market, broadly defined, as it is several times the size of developed countries' combined output (see table 1), the profound interconnectedness of financial institutions around the world, and the historically unprecedented opacity of the financial system.

These factors at least partially explain how an initial loss estimated at between US\$ 300 billion and US\$ 400 billion on the United States subprime mortgage market can have led to a crisis of this magnitude. As of early 2008, losses on assets originating in lending by the United States financial system appeared to be in excess of US\$ 2.2 trillion,

although the final figure will depend on the scale and duration of the recession.

Meanwhile, the crisis has generated losses on asset values, particularly share and house prices, equivalent to some 25% of global wealth. Figure 1 shows the scale of losses on the New York stock market in comparison with other crises of the last 80 years. As of late December, the stock markets of the world's leading economies had lost some 40% to 45% of their value, while in China the figure was over 60%. This drop in wealth is, along with uncertainty, one of the main factors behind the worsening recession.

The current financial crisis raises a variety of issues encompassing everything from its origins, its peculiarities and the factors compounding it to the question of what can be done to prevent it from worsening and how similar crises can be avoided in future. Some of these issues are discussed in this article which, following this introduction, devotes a second section to analysing the concurrent and determining factors in financial crises, particularly the present one. As there is no consensus about what causes crises, we thought it helpful to present (third section) some alternative explanations, many of which are complementary. The fourth section examines some factors that have exacerbated the crisis and that are familiar from the long-standing debate about moral hazard and systemic risk. The fifth section considers what could be done in the way of countercyclical policies to reduce the scale and duration of the current international recession, with particular emphasis on bank capitalization and fiscal policy. The sixth section offers a very stylized account of the effects of the crisis on Latin America, the difficulty of implementing countercyclical policies and the importance of having a global lender of last resort. The closing section contains some final reflections.

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<sup>1</sup> Reinhart and Rogoff (2008) record over 300 financial crises from 1800 to the present day. The frequency of crises has increased in recent decades (Bordo and Eichengreen, 2001); Laeven and Valencia (2008) list 125 crises between 1970 and 2007.

TABLE 1

**Size of the capital market: selected indicators, 2007**

(Billions of dollars, except where other units are specified)

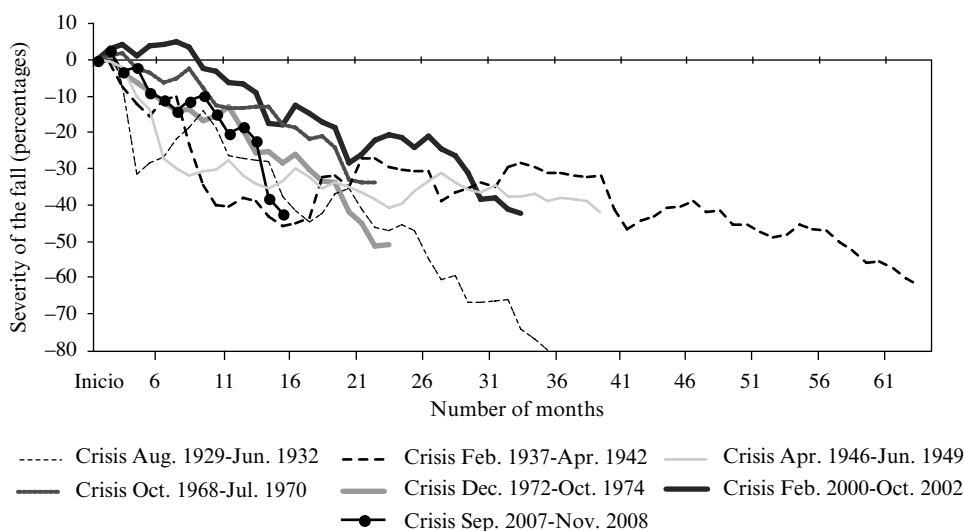
	GDP	Stock market capitalization	Debt securities			Bank assets	Bonds, shares and bank assets	Bonds, shares and bank assets (% of GDP)
			Public	Private	Total			
World	54.5	65.1	28.6	51.2	79.8	84.8	229.7	421.1
European Union	15.7	14.7	8.8	19.4	28.2	43.1	86.1	548.8
Euro area	12.2	10.0	7.6	15.4	23.0	30.1	63.5	520.1
North America	15.2	22.1	7.4	24.0	31.5	13.8	67.4	441.8
Canada	1.4	2.2	0.8	0.8	1.6	2.6	6.4	442.5
United States	13.8	19.9	6.6	23.3	29.2	11.2	61.0	441.8
Japan	4.4	4.7	7.1	2.1	9.2	7.8	21.7	495.7

Source: International Monetary Fund (IMF), *Global Financial Stability Report. Financial Stress and Deleveraging. Macro-financial Implications and Policy*, Washington, D.C., 2008.

FIGURE 1

**United States share prices during the financial crises of the last 80 years**

(Percentage drop in the Standard & Poor's 500 index, adjusted for inflation)



Source: prepared by the author on the basis of *Financial Times*, Standard & Poor's and Shiller, R.J. (2000), *Irrational Exuberance*, Princeton, Princeton University Press.

## II

### Concurrent and determining factors in financial crises

#### 1. Concurrent factors

Two elements have characterized all financial crises: the existence of a system, which means there is a network through which problems interconnect and affect many actors, and opacity of information, which means that different actors have different levels of information about the quality of financial intermediaries' assets and the characteristics of their liabilities (asymmetrical information).

Both elements have been particularly important in the present crisis. There has never been a financial system more complex and interconnected than the one developed during this phase of financial globalization. One manifestation of this is that in mid-2008 the derivatives market was worth US\$ 500 trillion, or nine times global output.<sup>2</sup> Furthermore, there is no precedent for the opacity characterizing the financial system in recent years. It became more and more difficult to understand the different "vehicles" and derivatives; the vocabulary used became more and more impenetrable as it turned into a specialist jargon. Operations became less and less transparent as a result.<sup>3</sup>

With regard to the first point, the outstanding example was the bailout of the world's leading insurance company, American International Group (AIG), in October and November 2008. This forestalled solvency problems at a number of financial institutions whose loans were guaranteed by AIG via credit default swaps. Considering the number of operations insured and the amounts involved (about US\$ 450 billion, including 55,000 subprime mortgages) and the amount of assistance (US\$ 150 billion to December 2008), it can hardly be doubted that AIG was insolvent.

The reason for providing an insolvent institution with this assistance was to ward off a systemic crisis, since the collapse of AIG could have dragged down a number of financial institutions and created a panic.

Practices like these undoubtedly increase moral hazard, an issue we shall return to later.

Regarding the second point, it is no surprise that information asymmetries should have been a determining factor in the sharp contraction of lending during the early stages of the crisis, both between financial institutions and in the commercial paper market. The first large increase in the cost of interbank credit came in mid-August, following months of house price falls in the United States and a fortnight in which a number of hedge funds went bankrupt; this happened despite huge funding injections by central banks (see figure 2). Nobody could be better placed than financial institutions to understand the characteristics of widely used instruments, realize that they were under growing strain and at the same time be aware of how hard it was to value the portfolios of other institutions.

In just a few weeks, information asymmetries gave way to total uncertainty: when events occur that radically alter a situation and destroy what agents thought they knew, the problem is not just that some are informed and others uninformed, but that nobody has the information they need.<sup>4</sup>

#### 2. The determining factors in the crisis: boom, euphoria and procyclical lending

While it is safe to say that interconnectedness, information asymmetry and, finally, a large dose of uncertainty are all necessary for financial crises to come about, we need to ask why they are recurrent. There is no simple answer, so it is hardly surprising that interpretations differ.

One important distinction between the different explanations is the role each assigns to the market and public policies. For some, financial crises are the result of errors connected with State intervention, whether at the microeconomic or the macroeconomic level;

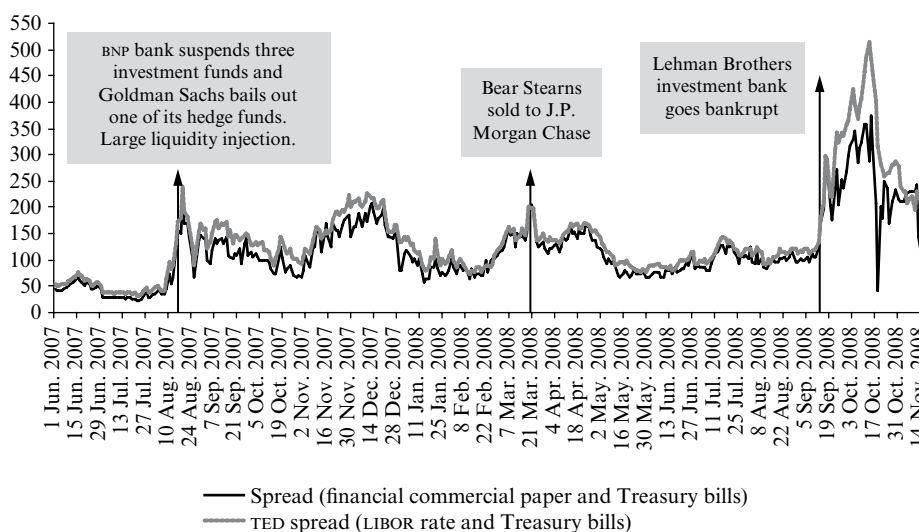
<sup>2</sup> US\$ 55 billion of this was accounted for by credit default swaps.

<sup>3</sup> See Mizen (2008) for a detailed description and analysis of the different instruments and vehicles.

<sup>4</sup> Bagehot wrote: "In England, after a great calamity, everybody is suspicious of everybody; as soon as that calamity is forgotten, everybody again confides in everybody" (Bagehot, 1920, pp. 124 and 125).

FIGURE 2

**Three-month interest rate spread: LIBOR, Treasury bills  
and financial commercial paper, 2007-2008**  
(Basis points)



Source: prepared by the author on the basis of Federal Reserve data.

N.B.: LIBOR = London interbank offered rate, TED spread = spread between the interest rate paid by banks and the yield on Treasury bills.

for others, they follow naturally from the workings of the financial system. While the former believe that the market ought to play a leading role, both in crisis prevention and in the search for solutions, the latter insist on the need to improve (and in some cases completely alter) the nature of regulations in order to prevent, or at least restrain, the procyclical behaviour of the system. In these cases a number of concurrent factors tend to be involved, and the present crisis is no exception. However, we believe that certain elements predominate, and it is these that will now be discussed.

(a) *Boom, euphoria and procyclical lending*

One well-known explanation for cycles of economic boom and bust concerns the behaviour of the financial system and is associated with the thinking of Minsky and Kindleberger.<sup>5</sup> The argument is that as the expansionary phase of the cycle proceeds, financed by burgeoning credit, there is growing confidence that the boom will continue and this increases the demand for

and supply of credit. Euphoria and the expansion of financing generate a bubble in some or all asset prices, creating a feeling that buying these assets on credit is a very profitable activity. In an increasing number of cases as the boom continues, credits can actually be paid down only if prices keep rising. As Minsky put it, “a regime in which capital gains are being earned and are expected is a favorable environment for engaging in speculative and Ponzi finance”.<sup>6</sup>

Credit growth, which often occurs in a context of loose monetary policy, is boosted during the expansion phase by increased leverage in the financial system, i.e., by a rising ratio between assets and equity.<sup>7</sup> Historically, this has been the result of innovations that demand less capital, including the emergence of new intermediaries, which has reduced the participation of traditional deposit banks in the financial sector. The extreme case is the United States, where financial

<sup>5</sup> See Minsky (1972, 1975 and 1986) and Kindleberger and Aliber (2005). Bordo (2008) reminds us that this explanation is rooted in the tradition of nineteenth-century monetary economics and was further developed by Irving Fisher (1933).

<sup>6</sup> Minsky (1986, p. 210). Financing is described as speculative when revenues are sufficient to pay off only the interest and not the capital; Ponzi financing is when revenues are not sufficient to pay capital or interest. In both cases, capital gains are essential to “survival”.

<sup>7</sup> This increased leverage observed by Minsky in the expansionary phase of the cycle has been corroborated by Reinhart and Rogoff (2008).

assets held by traditional deposit banks account for less than 25% of all financial institutions' assets (see figure 3).<sup>8</sup>

Higher leverage weakens the financial system, as capital is left more and more exposed to small asset losses. Since changes in leverage are procyclical, it peaks just when asset prices are starting to fall. The effects of price falls, and borrowers' diminished ability to pay in consequence, are thus amplified at this stage; in this way, the impact on system solvency is greatly heightened.

Solvency problems are intensified by another characteristic of the expansionary period. Considering that short-term interest rates are usually lower than

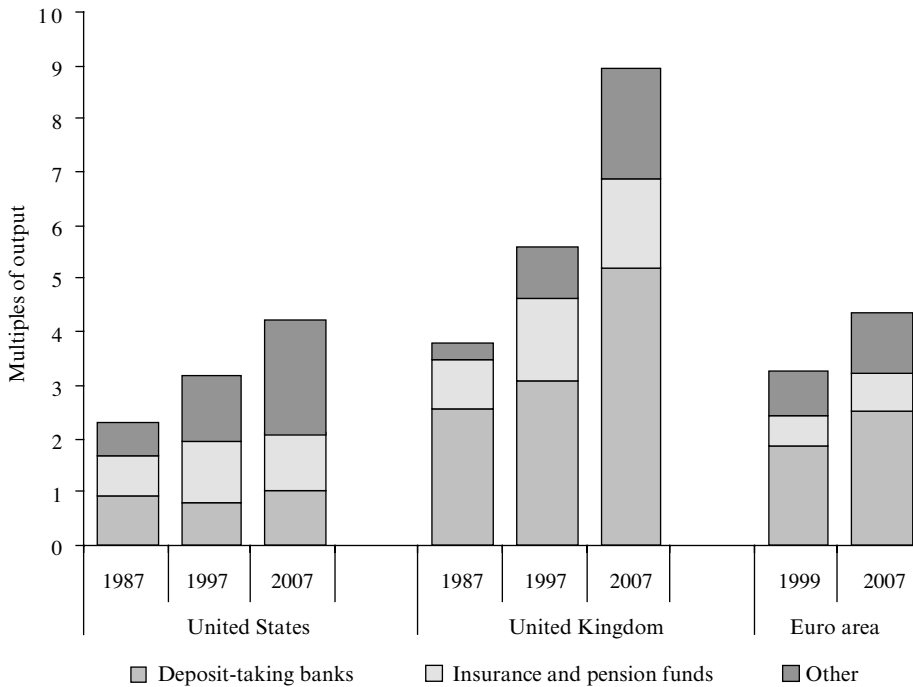
long-term rates, financial institutions usually finance the optimism of the boom by increasing their short-term liabilities. Too large a mismatch makes them more vulnerable to changes in market sentiment, as investors tend to reduce their financing once they start to observe difficulties with asset quality. The growing shortage of liquidity affects system solvency as institutions have to liquidate assets at "fire sale" prices to meet their obligations. The scale of the impact on solvency depends on a variety of factors, including the size of the bubble and the existence or otherwise of a lender of last resort which can resolve liquidity issues and prevent asset prices from falling too far.

In Minsky's view, instability is a characteristic of modern financial capitalism and arises because expectations are based on the past, leading to speculative and Ponzi behaviour. Why, then, do boom periods not always end in crises, as the logic of the model would appear to require? There are a number of answers, ranging from the size of the bubble to the triggers

<sup>8</sup> Although the size attained by other financial institutions is unprecedented, their existence and the importance of their role are not. A hundred years ago, the difficulties of trust funds and stock market agents were a crucial part of the explanation for the most critical developments in the 1907 financial crisis and its favourable resolution (Bruner and Carr, 2007).

FIGURE 3

**Size and distribution of financial assets**  
(Multiples of output)



Source: International Monetary Fund (IMF), *Global Financial Stability Report. Financial Stress and Deleveraging. Macro-financial Implications and Policy*, Washington, D.C., 2008.

for crises, but one particularly important factor is the existence in recessions of countercyclical policies that are manifested in higher fiscal deficits (partly because of automatic stabilizers) and financing for the financial system, whose role usually goes beyond that of lender of last resort. These are the policies that prevent recessions getting out of hand and situations of panic arising. Minsky warns that this capacity of countercyclical policies would be imperilled if the tendency towards excessive financial system liberalization and growing participation by other financial intermediaries were to continue.<sup>9</sup>

This view, which is predicated on the formation of expectations based on the recent past, has few points of contact with a view that assumes rational expectations; and indeed, if the latter were at work, it would be hard to imagine the behaviour of economic agents switching as rapidly as it does in crises, particularly when this change in expectations is not due to any significant shift in the behaviour expected from the public sector.

<sup>9</sup> See Minsky (1986, chapters 2, 3 and 4) and Papadimitriou and Wray's excellent introduction to the 2008 edition of Minsky.

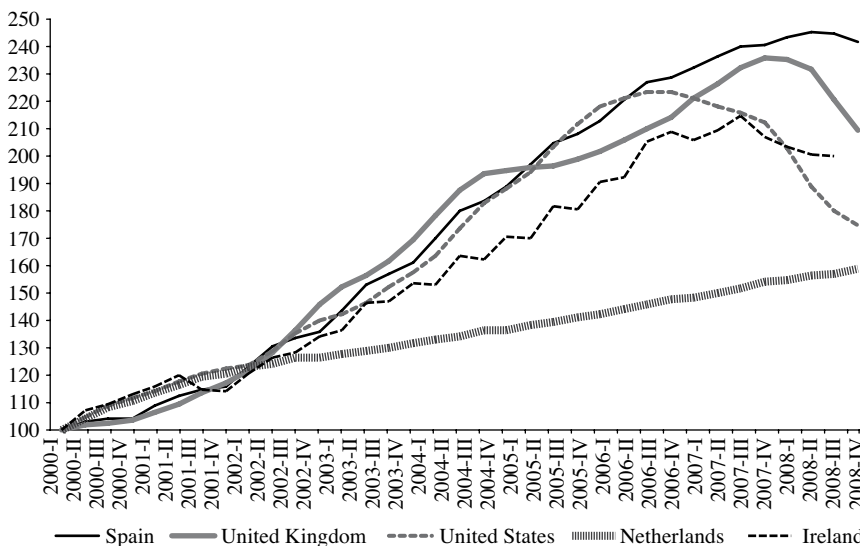
(b) *The 2007-2008 crisis*

The theory analysed in the previous section provides a fairly good explanation for the behaviour of the financial market in recent years, and particularly the sharp rise in house prices in the United States and a number of European countries (see figure 4). Falling property prices were the trigger for the crisis, as they exposed the poor quality of subprime lending, which was running at US\$ 600 billion a year in the United States in 2006 and represented 20% of all mortgage lending in the country. As prices dropped, this began to affect the “non-subprime” segment of the mortgage market.

To complicate the situation, the euphoria that usually goes with booms was compounded by the risk rating models used. These had two shortcomings. One was that in a number of countries, particularly the United States, they were based on information from the last five years, which is too short a time as it may reflect just one phase of the cycle; the other was the assumption in these models that actions undertaken on the basis of them would not, as in physics, influence the variables they were trying to predict. In this way, “herd” movements are accentuated and it is not possible to distinguish between one-off changes and systemic

FIGURE 4

**Selected countries: house prices, 2000-2008**  
(Quarterly data: 2000-I = 100)



Source: prepared by the author on the basis of data from the Spanish Ministry of Housing, Bank of England, Standard and Poor's, Statistics Netherlands and the Department of the Environment, Heritage and Local Government in Ireland.

shifts. In other words, crises cannot be explained by risk models that assume the world is stationary: at times of crisis, the parameters defined by stochastic processes are not stable, and therefore models based on these processes cannot be used to calculate risks (Fanelli, 2008 and Heymann, 2007).<sup>10</sup>

Supervision was obviously deficient, not only because market participants were not required to apply models based on more reasonable assumptions, but also because they were allowed to use different ploys to take excessive risks and increase leverage.<sup>11</sup> The inadequacy of supervision seems to have been due to a number of factors, ranging from low pay and capacity constraints at regulators to efforts to give local financial institutions an edge in the global marketplace. The most important factor, however, was an approach that had the effect of increasing self-regulation by placing the main onus on financial institutions themselves, which in this case chose the models that best served their growth strategies.

In mid-2007, when falling house prices began to affect the asset base of financial intermediaries and unsettle the market, the other factor mentioned above came to the fore: the volatility of bank financing as the role of deposits was taken over by placements in the capital markets and, much more seriously, by short-term commercial paper.<sup>12</sup> Deposits as a share of bank liabilities have been diminishing for several decades, from 70% in 1980 to just 40% in 2008 (IMF, 2008b).

Raising finance in the money markets and capital markets is a trend of recent years that is accounted for by the convenience of borrowing large amounts without having to incur administrative costs (for branches, salaries and advertising, for example). When this trend was supplemented by the aforementioned mortgage securitization, the picture was complete: the “deposit problem” was circumvented, leverage was enhanced and responsibility for lending quality was avoided.<sup>13</sup>

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<sup>10</sup> See Sotelsek and Pavón (2008) for a description and evaluation of the use of risk models.

<sup>11</sup> Special investment vehicles (SIVs) were the most notorious instance of this.

<sup>12</sup> A paradigmatic instance of this trend was Northern Rock, a bank that was nationalized in September 2007. See Milne and Wood (2008).

<sup>13</sup> In operations involving SIVs, banks generally undertook to supply liquidity or take back the loan in the event of solvency problems, so that those initiating the operation were left with a liability that would later affect them. Some investments of this type, furthermore, ended in the purchase of the bonds originally sold by the bank owning them (Mizen, 2008).

A final comment is needed on the distortion of lending incentives caused by asset securitization. The switch from bank to market as the central element in risk diversification has clear advantages in terms of liquidity and also allows risk to be diversified outside of a particular geographical area, including the borders of a given country. This assumes that information is transparent enough for investors to be aware of the risks of the “package” they are buying, a condition that was far from being met. Furthermore, replacing banks with markets raises some questions, since if all these were “pre-packaged” products, what would be the advantage in knowing the client, which was one of the main factors behind the rise of banks? Again, if knowing the client does not affect the profitability of a financial institution, where is the incentive for good lending?

The feeling that something was amiss with the assets of certain financial institutions, particularly those backed by low-quality mortgages, arose in full force between May and August 2007, when a number of hedge funds were faced with major losses and rating agencies reduced the ratings of bonds backed by mortgages of different qualities. The uncertainty was manifested in the market for short-term asset-backed commercial paper, which fell by half in just a few months (see figure 5). The consequence was a sharp reduction in the liquidity of all the banks that had turned to that market, irrespective of individual portfolio quality. Just as the solvency problems of certain financial institutions affected the liquidity of the system, initially because of information asymmetry and then increasingly because of the general uncertainty, the lack of liquidity fed back into these solvency problems.

To sum up, excessive leverage, the rise in short-term assets and the growing importance of under-regulated financial institutions became a dangerous mix that was hard to handle.

Lastly, a word about the remuneration of senior bank management, particularly in the developed world.<sup>14</sup> Over recent years, this remuneration has been linked to short-term profits and, in many cases, the number of operations completed. The different “vehicles” and increasing leverage contributed to higher profits in the short term, and thus to higher pay, irrespective of the medium- and long-term repercussions. Furthermore, the revenues of the rating agencies depended on

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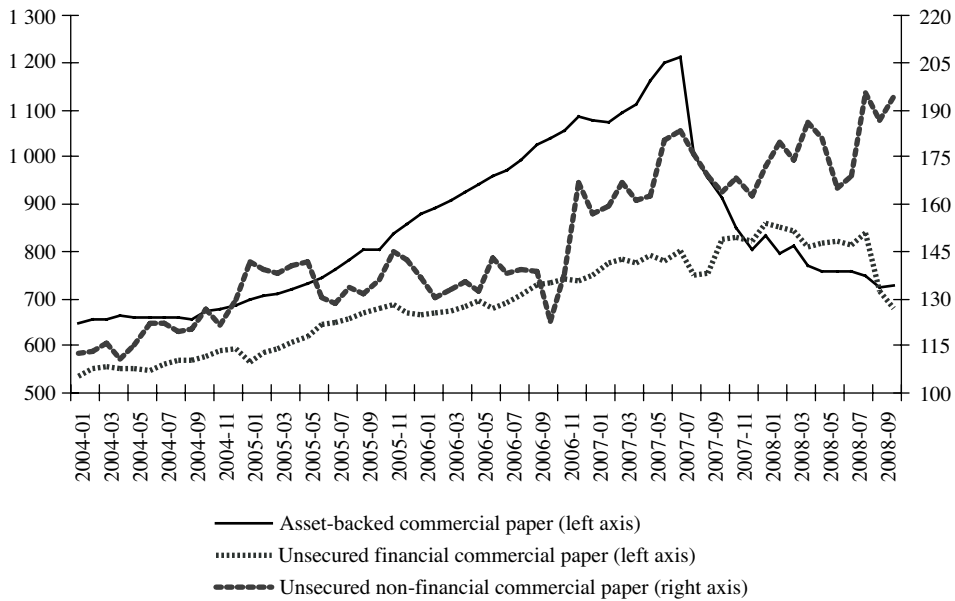
<sup>14</sup> Forty years ago, Galbraith (1967) warned of the growing importance of managers, whose goals were different from shareholders’.



FIGURE 5

**Asset-backed commercial paper and unsecured financial and non-financial commercial paper**

*(Billions of dollars, seasonally adjusted monthly data)*



Source: prepared by the author on the basis of Federal Reserve data.

intermediaries applying for assessment so that they could place their instruments in the market. They were thus both judge and party to the case. Considering the outcome, it seems they were more party than judge.

Executive pay and the role of the rating agencies contributed enormously to a model based on excessive risk-taking. Although they cannot be said to have caused the bubble and financial crisis, they undoubtedly propelled it to unknown heights.

As is usually the case, there is no one factor that explains the current financial crisis. Who could maintain that the policy of holding down interest rates for too long between 2001 and 2004 did not affect the subsequent situation? Before reviewing this and other arguments about the responsibility of economic policies for the crisis, some brief remarks should be made about the lack of incentives for implementing countercyclical economic policies during the boom.

(c) *The economics of the “never-ending” boom*

In an economic boom, procyclical lending, above-trend output growth and asset-market bubbles, particularly for property prices, are “good news”. The process is therefore hard to criticize. Not only are the

banks happy, but so too are businesses that see demand growing and can borrow more cheaply, not to mention people who are newly able to afford a first or second home and of course the owners of assets, who look on with pleasure as their wealth steadily expands. In this environment, the government can hardly feel anything but euphoric: the economic situation means that a majority of the population approve of the way it is running the country, and it can therefore win elections. In these circumstances, who would have the heart to spoil the party?

There will probably be analysts who cavil, but there will be many others writing clever articles to show that the above-trend growth in economic activity is because technological change has raised productivity on a more or less permanent basis; that property prices are still low considering changes in demand now that families aspire to own two homes; or, as has repeatedly been argued in several developing countries, that properties are still much cheaper than in... Paris or Rome! Furthermore, there will be those who justify large current-account deficits, either because they are “the result” of strong investment demand (even if this investment is going into non-tradable goods) or

because they are due to higher saving in the rest of the world, which someone “has” to absorb to maintain the global balance.

In short, economic policy during boom periods is highly conducive to excess. It is no coincidence that the clamour for countercyclical policies is heard loudly at times of recession but very rarely in the

expansionary phases of the cycle. This is why there are reasons to doubt the ability of the authorities to regulate cycles.<sup>15</sup> The most advisable course would seem to be to reduce their room for manoeuvre by introducing some countercyclical rules. Although such measures will certainly be difficult to impose, now is the time to do it.

### III

## An alternative explanation: monetary and financial policy errors

There are two lines of argument that emphasize economic policy errors as explanatory factors in financial crises. The first stresses the conduct of monetary policy; the second has microeconomic foundations and centres on the financial system safety net, be it implicit or explicit, which reduces the cost of the crisis for the different actors involved (banks and investors).

#### 1. Monetary policy

According to this viewpoint, the current crisis is due to an overly expansionary monetary policy run by the Federal Reserve from late 2001 to December 2004, manifested in Federal Funds rates of less than 2%. Although the European Union and the United Kingdom applied a similar policy, rates were cut by less and the period of low rates was less prolonged (see figure 6).

From a more structural point of view, it may be argued that the low interest-rate policy was driven by an excess of “lendable” funds in the international market, produced by: (i) the Chinese policy of maximizing exports and building up international reserves, (ii) the policy of building up reserves for self-insurance purposes in Brazil, China, the Russian Federation, the Republic of Korea and various developing countries and (iii) the policy in oil-exporting countries of accumulating resources in sovereign funds. This increase in saving in the “rest of the world”, it is argued, offset the low saving rate in the United States and accounted for the current-account deficit in that country, which was thus surprisingly able to combine lower saving with lower interest rates (Roubini, 2005 and Eichengreen,

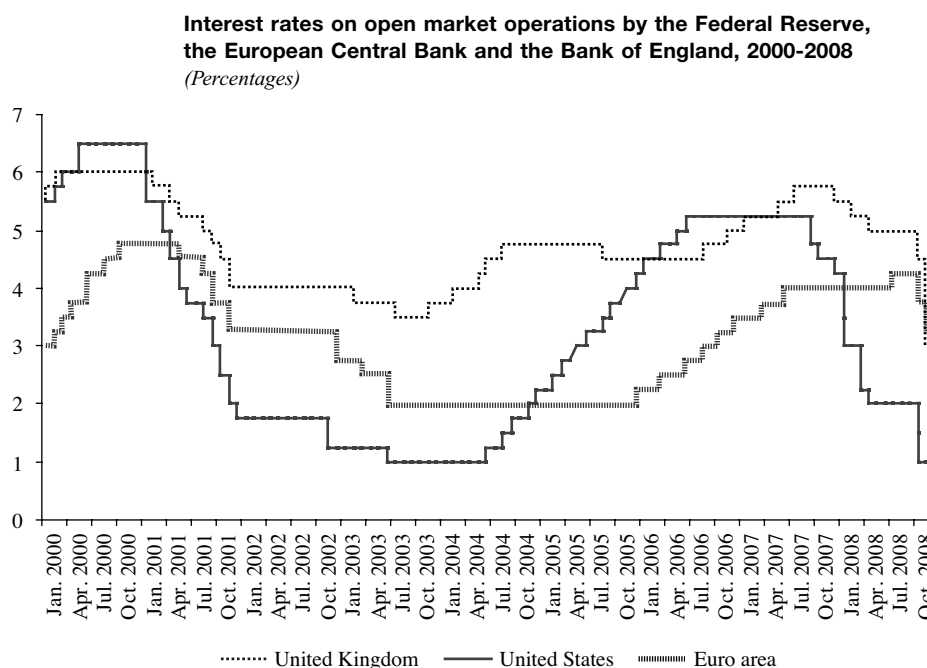
2005). Although this interpretation holds true where the abundance of “lendable” funds in international markets is concerned, it needs to be qualified by the observation that, even leaving the United States out of the equation, there was no increase in the global saving rate, as the rise in the countries mentioned was offset by lower saving in the rest of the world, particularly Japan and Europe. Furthermore, what has been seen in recent years in the rest of Asia, with the exception of China, is that “excess saving” has basically been due to lower investment.<sup>16</sup>

Whether they were due to structural causes, monetary policy or both, low interest rates were conducive to excessive lending growth. However, the emphasis in this argument needs to be weighed carefully. In the first place, as figure 6 shows, central bank interest rates in Europe and the United Kingdom were reduced by less than the Federal Reserve rate, yet there was also a house price bubble in a number of European countries. Furthermore, while there were fewer subprime mortgages in Europe than in the United States, this could have been due to more appropriate regulation or, probably, to the greater depth of the mortgage market in the United States resulting in “prime” mortgage lending opportunities running out earlier than in other countries.

<sup>15</sup> See, for example, Gerchunoff (2008, p. 1), who has argued that “examining these failures can provide lessons for the future, but crises are inevitable in a capitalist world sustained by ‘animal spirits’ and in a democratic world sustained by the hope of social progress”.

<sup>16</sup> See Eichengreen (2005).

FIGURE 6



Source: prepared by the author on the basis of data from the Bank of England, the Federal Reserve and the European Central Bank.

Secondly, the current crisis cannot be attributed to a constriction of the money supply as discussed by Friedman and Schwartz (1963) in relation to the 1929-1932 period. While there was a marked reduction in the bank multiplier this time around, as then, the increase in the monetary base more than made up for it.<sup>17</sup>

Lastly, it needs to be asked whether holding down short-term interest rates over a fairly long period may have caused the house price bubble and subsequent crisis. It must certainly have had an effect, particularly as it may have created expectations that monetary policy would not “permit” a recession and that, consequently, the prices of certain assets would carry on rising. However, medium- and long-term interest rates fell by considerably less (see figure 7), making it difficult to justify the rationality of a financial institution deciding to grant a 30-year mortgage because the short-term interest rate was very low. It may have provided a way

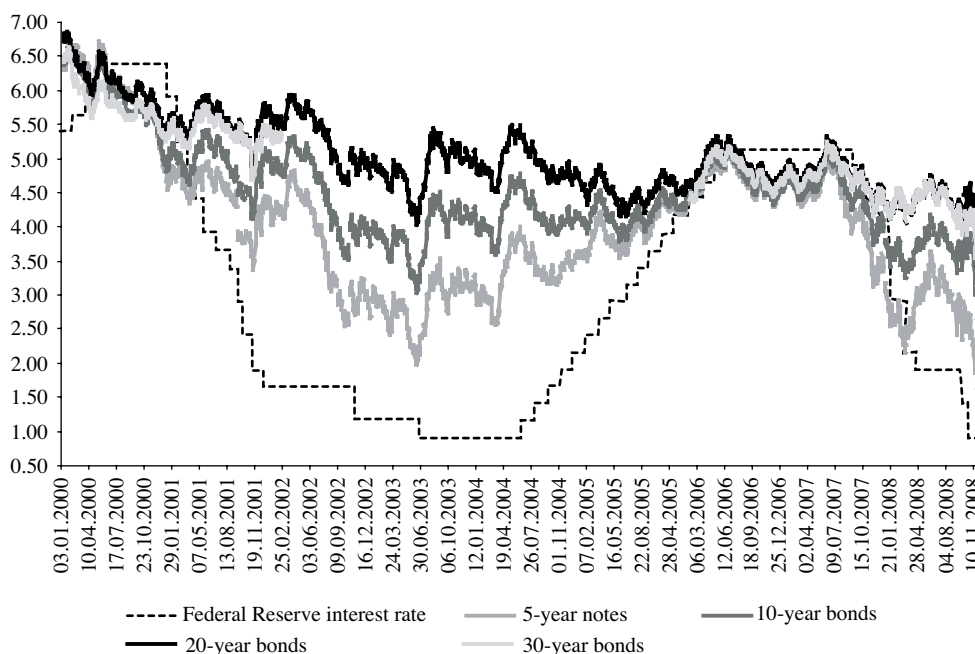
of offering three years of low introductory mortgage rates to tempt buyers with little financial knowledge, but it cannot be supposed that financial institutions extrapolated this situation to the medium and long term. Or did someone think that low interest rates were not among the instruments of countercyclical policy and therefore would not rise in the expansionary phase of the cycle? Again, why did credit continue to expand in 2005 and much of 2006, at a time when the Federal Reserve was rapidly raising interest rates, sending a clear signal that the period of low rates was over? The answer lies not so much in monetary policy as in the fact that the incentive to increase lending was not the long-term profitability of the financial institution but the year-end bonus or payment per operation concluded.

To sum up, it is possible that keeping interest rates low over a long period of time may have influenced the behaviour of the different actors, but this can hardly be claimed as the underlying cause of the housing market bubble in the United States and several European countries. The economic policy mistake of this period was certainly the failure to come to grips with the “irrational exuberance” of the markets, but it is not clear that this ought to have been a job for monetary policy. If interest rates are already called

<sup>17</sup> In the 1930s, the reduction in the multiplier was due to the increase in demand for cash over bank deposits (Bernanke, 2000), while in the current crisis it was a consequence of the extraordinary rise in bank reserves. In the United States, reserves represented 5.4% of the cash held by the public in July 2008, but by November 2008 that figure had risen to 79.3%.

FIGURE 7

**United States: interest rate on Federal Reserve open market operations and yield on Treasury securities**  
(Percentages)



Source: prepared by the author on the basis of Federal Reserve data.

upon to control inflation and, at least in the United States, regulate the level of economic activity, it seems excessive to burden them with an additional task like that of bringing an asset price bubble under control. The reasonable thing would have been to use some other instrument, the most obvious choice being measures to regulate the system, particularly higher capital requirements during the boom.

## 2. The safety net

A second explanation pointing to faulty public policies is the one traditionally maintained by the International Monetary Fund (IMF) and World Bank. The central idea is that the “excessive” presence of public safety nets prevents the discipline of the market from operating and thus encourages excessive risk-taking. In relation to the present crisis, this view is put forward in an article by three World Bank analysts (Caprio, Demirgüç-Kunt and Kane, 2008) who argue that the problems of the crisis have included inadequate regulation and oversight that failed to keep pace with financial innovation. In the tradition of World Bank

documents, however, the emphasis is placed on the existence of explicit or implicit subsidies provided via the different countries’ safety nets.

The argument is, then, that crises derive from an incentive structure which encourages the idea that the authorities will have to bail out shareholders and investors in financial institutions if they get into trouble. In other words, excessive risks are taken during booms because actors do not believe the market will ever punish them, given the “providential” presence of the public sector. This is what is known as moral hazard.<sup>18</sup> One example of it, according to the authors, was the rescue of Bear Stearns during the latest crisis, when the problems were those of insolvency; according to

<sup>18</sup> In a world of rational expectations and Ricardian equivalence, if a public-sector bailout is expected then the different economic agents ought to reduce their outlays by an amount similar to the cost of the State intervention, i.e., to the increase in debt and thus in future taxes. In other words, moral hazard will create an incentive for greater risk-taking, but at the same time will lead to a reduction in demand, two effects that could ultimately offset each other, at least where their effects on the cycle are concerned.

the authors' logic, the liquidation of Lehman Brothers was the right step to take.<sup>19</sup> Following this approach, the aim should not be for risk-taking to be reduced through regulation but for the market to penalize those who get it wrong. This would mean reducing the size of the safety net, whether explicit or implicit.

This discussion revolves around two concepts: systemic risk and moral hazard. Generally speaking, what generates systemic risk is the lack of perfect information on the solvency and liquidity of financial institutions, although it can also arise when such perfect information is available, as it "may be rational behaviour to withdraw deposits from a solvent financial institution if one thinks it may cease to be solvent as a result of a run on its deposits by other depositors. In this case there are rational expectations that are conditional on the behaviour of other agents, whose level of information is unknown" (Machinea, 2002, p. 14).

History shows us that, following the 1930 crisis, it is hard to find situations of acute financial crisis that have not led to significant intervention by the economic authorities.<sup>20</sup> In other words, priority has been given to systemic risk over moral hazard (Goodhart, 1999). The reason is obvious: a systemic crisis can generate high costs in terms of lower output and higher unemployment, while the costs associated with moral hazard do not look so considerable, or at least seem to be remote in time. Furthermore, two strategies have generally been used to reduce the moral hazard of public intervention: (i) "constructive discretion" and (ii) the policy of not bailing out bank shareholders. The former means that the central bank is not explicit

about the policy it intends to follow towards financial institutions in difficulties.

However, the problem with the strategy of reducing moral hazard by punishing shareholders is that the management of a number of major financial institutions tends to be quite independent. In particular, executives who receive extraordinary bonuses linked to short-term profits are usually unaffected by any action aimed at punishing shareholders.

In summary, if the two principles set out above are adhered to, it seems unlikely that bankers and investors will take on so many risks when the probability of a bailout is substantially less than 1 and profits have to be weighed against a prospective loss of 100% of capital.

It has been argued in this connection that if systemic risk is the result of information asymmetry, the best way to resolve it is through greater transparency, so that runs on particular financial institutions are the result of the purging effects of the market rather than confusion among savers about their solvency.<sup>21</sup> Considering the costs of obtaining and interpreting individual information, the solution would be for advice to be provided by specialists who would benefit from clear economies of scale. This is the role that ought to be played, for example, by the rating agencies. The role they actually have played in several of the most recent crises, but particularly the present one, obviates the need for any further discussion of the subject.

It may be mentioned here that a number of the region's countries substantially reduced their safety nets in the 1990s, while the flow of information in the market increased. Safety nets continued to be removed for as long as it took the crisis to appear.<sup>22</sup>

<sup>19</sup> A similar argument is made by Bordo (2008). However, it is difficult to understand how moral hazard could have been an issue in the case of shareholders, whose shares lost just over 90% of their value compared to a year earlier.

<sup>20</sup> By "significant interventions" are meant those that exceed the deposit guarantee designed to protect uninformed small depositors. At present, runs on financial institutions are usually led by large depositors.

<sup>21</sup> See Calomiris and Gorton (1990) and Calomiris and Powell (2000).

<sup>22</sup> See Machinea (1996) and Rozenwurcel and Bleger (1997) for a critical review of these reforms in Argentina.

## IV

### How the crisis spread: prioritizing moral hazard

In early September 2008 there was a major credit crunch and interbank credits were difficult to obtain, even though the premium over United States Treasury bills in the commercial paper and interbank markets was below the average of the previous 12 months (see figure 2). The disappearance of Bear Stearns via its takeover by J.P. Morgan had confirmed the perception that some financial institutions were too big to fail, including the investment banks. Creditors got their money back and the only ones to be penalized were shareholders, who recovered less than 10% of what their shares had been worth a year earlier. Thus, a worsening of systemic risk was avoided without creating moral hazard for shareholders.

The situation changed radically on 15 September following the liquidation of Lehman Brothers; losses for the financial system as a whole as a result of that event are put at US\$ 500 billion. The reading of the markets was that any intermediary could be liquidated, regardless of size, with all the effects on the system this implied. At this signal, panic spread and the credit markets seized up. In the interbank market, the interest rate rose by 175 points over Treasury bill yields in 10 days and 350 in a month (see figure 2); much

the same happened in the commercial paper market. Everything suggests that the financial markets were just hours away from a complete meltdown.

The lesson, which is not a new one, is that disciplining the market in the middle of a crisis is not so much mistaken as outright foolish. The Lehman Brothers bankruptcy may have brought some order to other actors, as is shown by the fact that the sales operation of Merrill Lynch was shut down the same day, but in the days that followed it became clear that while the medicine had been effective in disciplining some investment banks, it had exacted an extraordinarily high cost for the stability of the system. If there was any doubt as to which needed to be given priority in a crisis, systemic risk or moral hazard, the Lehman Brothers bankruptcy will probably go down in history as the episode that ended the debate... at least for a while.

The problem of moral hazard is still there, of course, but it cannot be eliminated at the cost of imperilling the world economy. While it may be argued that the collapse was due to underlying structural causes that went beyond Lehman Brothers, there can be no doubt that its liquidation made the crisis more likely to worsen.

## V

### From bailing out financial institutions to bailing out the economy

The search for an answer to the question of what is needed to end the crisis has occupied many economists and politicians over recent months, and this search has yielded different proposals. Leaving aside the need to rethink the way the international financial system operates, however, the answers have been converging upon two elements on which action ought, in our view, to be taken in the short term: restoring

a “certain level” of lending and using fiscal policy to boost demand.

#### 1. Credit and the financial system

To restore a certain level of lending, one necessary step is to reduce the uncertainty surrounding financial institutions. Accordingly, the measures taken since

mid-September have aimed to restore the liquidity and solvency of these institutions. This has required huge public-sector intervention involving sums so large that they would have been unimaginable just months before.

Specifically, to improve liquidity the public sector decided, with some variations between countries, to guarantee the liabilities of financial institutions by raising deposit guarantee limits (or removing them in extreme cases) and guaranteeing interbank credits and placements on the capital markets. Thanks to these measures, the costs of financial institutions' liabilities fell and much of their liquidity was restored.

However, the increase in liquidity has not translated into a rise in lending to the private sector, for three reasons. Firstly, financial institutions still feel a degree of uncertainty about renewing their liabilities, even though the situation is starting to normalize. This is forcing them to maintain a higher level of liquidity than usual, something that has been manifested in the increase in bank reserves already referred to. This is a variant on the liquidity trap, as it prevents monetary policy from being effective in reducing interest rates on loans to the private sector.<sup>23</sup>

The second reason is the loss of bank capital and thus the need to re-establish the ratio between capital and assets. The third is uncertainty about the solvency of potential customers in the context of a deepening recession.

To resolve or at least palliate the problem of solvency among financial institutions, public-sector measures were initially aimed at purchasing toxic assets and, increasingly, at using State funds to capitalize these institutions. The problem with this measure is the difficulty of estimating portfolio quality in the midst of a recession, and thus of calculating how much fresh capital is needed. Given the news items appearing daily in the media about different banks requiring further capital injections after already receiving assistance, the time has come to take some final decision that can significantly reduce uncertainty. One alternative, which worked in the Nordic countries in the early 1990s, is temporary nationalization of banks. The second would be for the public sector to buy toxic assets from financial institutions and set up a "bad bank", but the difficulty here would be in setting the price: paying the market price would

not solve the problem, but paying nominal values would be tantamount to making a gift of taxpayers' money to the banks.<sup>24</sup> A halfway solution would be to acquire assets at an above-market price but with the stipulation that the bank thus benefited is obliged to repay out of future profits the difference between that value and the amount ultimately recovered.<sup>25</sup> In this case and for the duration of the emergency, the debt would have to be excluded from calculations of the institution's net worth given that it would be set against profits.<sup>26</sup> Another alternative is to create a new "good bank" from the sound assets of existing banks. Creditors (other than guaranteed deposit-holders) and shareholders in the rump banks would only get back whatever they could recover from the "bad" assets plus the difference (if positive) between the "good" assets and the guaranteed deposits transferred to the new bank (Buiters, 2009). Although this option entails the smallest fiscal cost in the short run, it is also the one that would generate the greatest uncertainty because of the large losses that would affect unsecured creditors. However, if a decision is not taken soon, rising losses will mean that the final option is the only viable one.

Partly because of undercapitalization, but also due to the other two factors mentioned earlier, particularly the uncertainty associated with the recession, the Federal Reserve took a step that would have been unthinkable a few months ago, although it is not without precedent in financial history: it decided to lend directly to the private sector by purchasing commercial paper.<sup>27</sup> In early 2009, for its part, the Bank of England announced that it would guarantee some lending to small and medium-sized enterprises.

<sup>23</sup> See Krugman (2008) for an ingenious demonstration of the importance of fiscal policies in this context.

<sup>24</sup> This alternative is akin to guaranteeing part of banks' existing assets.

<sup>25</sup> The bank itself could be given the portfolio to administer. The incentive is obvious: the more it recovers, the less it will have to pay back.

<sup>26</sup> This obviously cannot become normal practice, but it could be applied for the duration of the emergency.

<sup>27</sup> Although it is unusual, history does record similar episodes. For example, Bagehot quotes the words of a Bank of England director in the 1825 crisis: "We lent it on behalf of the Bank of England by every possible means and in modes we had never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank..." (Bagehot, 1920, p. 52). In 1970, furthermore, after the collapse of the Penn Central railway company, the Federal Reserve provided credits to non-financial firms, taking commercial paper as security.

From being lenders of last resort, in other words, central banks have become the only lenders.

Unfortunately, the current hyperactivity does not make up for the lack of earlier action to control the financial system and the property bubble. Beyond the extraordinary costs of the assistance package, financial measures are unlikely to re-establish growth. Their central aim is to prevent a depression occurring because of bank closures and the disappearance of credit. It is one thing to prevent credit from “disappearing”, but quite another to restore it to normal levels. Further pressure needs to be brought to bear on financial institutions assisted by the public sector so that they start lending again, and although there is scope for the State to guarantee some new credits, everything suggests that the process of restoring lending to normal levels will take a great deal of time. This is not only because of the supply factors referred to, but also because solvent potential borrowers will hardly be in a mood to take out loans for durable goods purchases or investment in this climate of uncertainty. This is a further obstacle for monetary policy, since the liquidity trap is being compounded by another of the factors emphasized by Keynes: the low interest-rate elasticity of spending in a climate of depression.<sup>28</sup>

## 2. The need for a fiscal stimulus

Based on the arguments in the previous paragraph, there is a need to increase the fiscal deficit as a mechanism for stimulating demand. This does not mean neglecting the important role of monetary policy, including further cuts in interest rates; otherwise credit and confidence would collapse and no fiscal measures would be sufficient to ward off a major depression.

It should be said that before the present crisis there was a degree of consensus, at least in the United States, that the best way of conducting countercyclical policy was by means of automatic fiscal stabilizers and monetary policy.<sup>29</sup> In other words, discretionary fiscal policy was ruled out on the basis of some historical evidence and of arguments that were central in the

debate between monetarists and Keynesians in the 1960s and 1970s, such as the time it took to put fiscal policies into effect once they became necessary given the process involved (diagnosis, preparation, support from Congress, tendering), the “crowding out” of the private sector as a consequence of higher interest rates, and the lower fiscal multiplier posited by theories of permanent or life cycle income.<sup>30</sup>

However, the scale and likely duration of the current crisis and, particularly, the limited or negligible effectiveness of monetary policy in a situation like the present one have silenced a number of these objections (Taylor, 2008b; Blinder, 2008). Discussion seems to have centred now on the type of fiscal stimulus; the “monetarists” recommend tax cuts (designed to reach as many people as possible) or subsidies, both on a permanent basis (Taylor, 2008b). We believe that to settle on solutions of this type would be a mistake, because it is not the moment to adopt permanent measures that merit more thorough discussion and because resources need to be targeted, for reasons of equity and efficiency, on the sectors most affected by the crisis. We say “efficiency” and not just “equity” because these are the sectors for which liquidity constraints are critical to spending decisions. The developed countries have established a system that acts as an automatic stabilizer: unemployment insurance. The idea is to increase, exceptionally, the amount of the subsidy or the time it is paid so that it becomes something more than an automatic stabilizer. Supplementary measures could include subsidizing the mortgage payments of certain borrowers (unemployed and lower-income) and financing local public works, which tend to be relatively small-scale and quick to execute. To these might be added fiscal measures to favour present consumption over future consumption. What needs to be clear is that in this case efficiency is to be gauged not by the “quality” of spending but by its effects on overall demand and the speed with which it can be implemented (IMF, 2008a).

The measures referred to should not include tax cuts, since in an atmosphere of crisis and uncertainty a lower tax burden will probably not translate into substantially higher spending, particularly given the difficulty of targeting tax cuts on lower-income sectors or those most affected by the crisis. Unfortunately,

<sup>28</sup> The fact that interest rates have less effect on demand does not mean that reducing them does not cause disposable income to rise. The most obvious case is the relationship between European Central Bank rates and EURIBOR, the rate to which most mortgages are indexed.

<sup>29</sup> The United States was one of the few countries where monetary policy played this role on different occasions; elsewhere, an “extreme” version of inflation targeting sometimes prevented monetary policy from playing a countercyclical role.

<sup>30</sup> See, for example, Feldstein (2002), Auerbach (2002), Taylor (2000 and 2008a) and Blinder (2004), although this last does say that fiscal policy would be necessary in “extreme situations”.



political negotiations are increasingly tending in this direction. It would be a grave mistake to increase debt in these circumstances without being sure what the effect on demand will be.

In summary, what is needed is a large-scale fiscal incentive that has substantial repercussions on demand and can be brought in as quickly as possible. Although it may sometimes seem doubtful that any fiscal stimulus can offset the sharp fall in private-sector investment and consumption, the idea is not to reverse the short-term trend but to find a floor for the recession that might help to change expectations.

To increase overall demand significantly, there needs to be a coordinated effort involving both developed and developing countries. It is worth remembering here that developing countries were key actors in the recovery from the 2001 recession, as they have accounted for over 60% of global growth in recent years. China and India have obviously been the main actors in this new situation. With a few exceptions, however, developing countries have far

less scope to implement countercyclical policies than developed ones.

Two concluding remarks are called for. First, the prospects of success will be lessened if some of the major developed and developing countries do not cooperate, and there will also be a problem of inequity: in a globalized world of more open economies, those that do not participate will benefit from the efforts of those that do. Second, it is important not just to increase spending, but to ensure that fiscal policy does not include more or less covert “national procurement” clauses. While these do make fiscal packages easier to pass, there are two problems with them. The first is the risk of triggering protectionist policies; the world experienced the consequences of these once before in the 1930s, but they would be far greater today. The second is that developing countries would be the worst affected, both by protectionism and by the fact that countercyclical policies, as analysed in the next section, will be applied on a greater scale in the developed countries.

## VI

### Developing countries: the needs and limitations of Latin America

#### 1. Overview of the situation

As must inevitably be the case in a globalized world, developing countries have begun to experience the effects of the financial crisis. In Latin America these effects have been felt through two channels: a real channel and a financial one.<sup>31</sup>

Through the “real” channel, Mexico and the Central American countries are being affected by the drop in industrial exports and remittances and by the fall-off in tourism and foreign direct investment (FDI). Lower commodity prices are having a major impact in South America and, to a lesser extent, Mexico; lower oil prices will favour Central America, however (ECLAC, 2008a and 2008b).

Table 2 summarizes a number of the effects of the crisis on the current accounts of the region’s countries. The table was prepared using 2008 current accounts, with the adjustments consequent upon the international financial crisis (“exogenous factors”). In other words, it does not take into account the internal adjustments (exchange rates and level of activity) that would be necessary if higher current-account deficits could not be financed. It is assumed that total imports remain unchanged, which is compatible with a growth rate of 3% if investment declines substantially because of negative expectations and the lack of financing.<sup>32</sup> Exogenous variations reflect changes expected in: (i) export and import prices, (ii) industrial export volumes, (iii) remittances, (iv) tourism revenues and

<sup>31</sup> Considering that there is an article in this edition of *CEPAL Review* specifically discussing the impact of the crisis on Latin America, here we shall offer a stylized account of certain developments.

<sup>32</sup> If capital goods imports (which represent about 25% of all imports) declined by 15%, this would leave room for imports of other products to increase by 5%, which is compatible with 3% growth.

TABLE 2

## Latin America: current-account balance and financing requirements

	Percentages of GDP				Millions of dollars	
	2008	2009 scenario 1 <sup>a</sup>	2009 scenario 2 <sup>a</sup>	Average 1997-1998	2009 scenario 1: adjusted current-account balance	2009 scenario 1: financing needs net of FDI
Argentina	3.7	-1.4	-2.4	-4.5	-4 027	-352
Bolivia (Plurinational State of)	14.8	6.8	5.6	-7.4	942	0
Brazil	-2.0	-3.4	-3.7	-3.7	-45 450	-30 450
Chile	-3.3	-9.7	-9.6	-4.7	-16 507	-8 130
Colombia	-3.0	-4.6	-5.8	-4.6	-9 794	-3 311
Costa Rica	-9.0	-9.6	-10.9	-3.7	-2 606	-1 205
Dominican Rep.	-13.6	-14.4	-15.4	-1.3	-6 191	-4 316
Ecuador	3.2	-7.3	-10.8	-5.4	-3 558	-3 033
El Salvador	-6.4	-7.8	-9.4	-0.8	-1 636	-1 308
Guatemala	-5.3	-7.1	-8.3	-5.0	-2 449	-1 872
Haiti	-2.7	-3.9	-5.3	-1.2	-245	-222
Honduras	-13.2	-14.7	-15.2	-3.5	-1 878	-1 204
Mexico	-1.5	-4.0	-5.2	-2.9	-41252	-31 433
Nicaragua	-29.7	-28.5	-28.3	-22.0	-1 684	-1 384
Panama	-10.0	-9.2	-10.5	-7.2	-1 949	-599
Paraguay	-2.6	-14.7	-14.5	-4.8	-1 882	-1 725
Peru	-4.8	-8.6	-9.1	-5.8	-10 108	-5 233
Uruguay	-4.3	-4.0	-4.3	-1.7	-1 026	0
Venezuela (Bol. Rep. of)	16.6	1.3	-3.2	-0.4	3 213	0
Latin America	-0.7	-4.0	-5.1	-3.7	-148 087	-91 306

Source: prepared by the author (see annex).

<sup>a</sup> Current-account balances in 2009 are expressed in terms of 2008 GDP. See annex for the assumptions involved in the two scenarios.

(v) in some countries, a drop in rents from natural resource exploitation being sent abroad. All these variables are calculated for two alternative scenarios, presented in the annex. The results show the scale of the problem: in the least pessimistic scenario, the current-account deficit increases by an average of 3.3 points of national output to 4%, exceeding the 1997-1998 figure (see table 2). In the rather more pessimistic scenario it reaches 5.1% of GDP. To complicate the situation, foreign direct investment is expected to fall sharply, reducing one of the least unstable sources of financing for the current account. On the less pessimistic hypothesis (25% drop), net FDI would be equivalent to 1.6% of output in the region as a whole. This implies a financing shortfall of US\$ 91 billion (US\$ 138 billion in the more pessimistic scenario), 68% of it in two countries, Brazil and Mexico (see table 2).

To this must be added the maturity of external debts, which different estimates put at US\$ 120 billion, giving a total of US\$ 210 billion. Financing this imbalance will not be easy, as the repercussions of the crisis are being manifested via the “financial” channel in higher country risk (see figure 8). In fact,

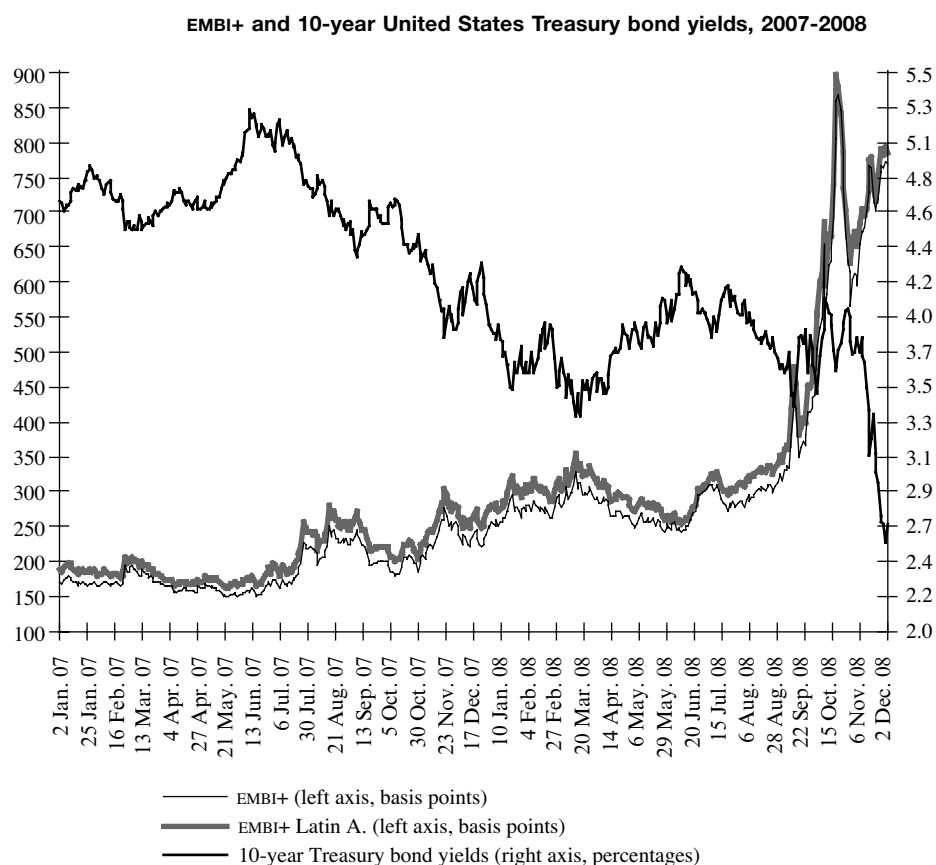
a number of countries (Argentina, Ecuador and the Bolivarian Republic of Venezuela) have no access to international credit. Furthermore, private-sector debt is going to be difficult to roll over, as this would require a normalization of the financial market in relation to the fourth quarter of 2008, when outflows of private capital led to sharp devaluations. These have affected the liability situation of private-sector firms, although the most significant effect has been the “disappearance” of credit, which has left many of them on the verge of default and operating with very short-term credits.<sup>33 34</sup>

Depending on the characteristics of each country and the economic policy measures adopted, the lack of new international financing will affect international reserves, the real exchange rate and the level of economic

<sup>33</sup> The situation is even more critical in a number of eastern European and Asian countries, particularly the Russian Federation. See J.P. Morgan (2008).

<sup>34</sup> A number of corporations, particularly in Brazil and Mexico, had made bets in the derivatives market against a devaluation of the local currency. This led a number of them into substantial losses and even bankruptcy.

FIGURE 8



Source: prepared by the author on the basis of Federal Reserve data and J.P. Morgan.  
 N.B.: EMBI+ = Emerging Markets Bond Index Plus.

activity. In other words, the lack of financing can be offset, at least in part and for a limited time, by running down international reserves. If this proves insufficient, the other two instruments for adjusting the external imbalance will be devaluation of the real exchange rate and a lower rate of economic activity. In the fourth quarter of 2008, a combination of simultaneous changes in these three variables could be observed.

Although no exercise has been carried out to show the effects of the crisis on the public accounts, the close relationship between export commodity prices and fiscal revenues means that the latter are expected to fall substantially (Jiménez and Tromben, 2006). By way of compensation, sizeable energy subsidies, which in 2008 stood at over one point of output in several countries, will be reduced. According to the Economic Commission for Latin America and the Caribbean (ECLAC, 2008b), fiscal deficits will increase by about 1.5% of output in 2009. While this estimate

may be on the optimistic side, the difference between this and other crises in terms of fiscal solvency is, thankfully, staggering.

To cope with the crisis, then, it will be necessary to implement countercyclical policies designed to offset the drop in demand (both external and internal) and finance the external and fiscal imbalances. Unsurprisingly, the two issues are clearly intertwined.

## 2. Countercyclical policies

Given the current global economic situation, we need to ask what developing countries, and Latin America in particular, can do to implement countercyclical policies. The short answer is: considerably less than the developed world.<sup>35</sup>

<sup>35</sup> There are exceptions: the most striking is China, whose extraordinary level of savings and international reserves is allowing it to implement expansionary policies.

First of all, the channels through which assistance to the sectors worst affected by the crisis might be increased are not obvious, partly because most developing countries do not have unemployment insurance, or at least none that works effectively and has adequate coverage. Beyond channelling more resources into anti-poverty programmes and implementing public works in local areas, therefore, there is an urgent need to find other ways of reaching the middle-income sectors being affected by the crisis (such as funding existing health-care coverage for a certain period of time and paying a larger allowance per child).

Secondly, and most importantly, at times of crisis there is a clear macroeconomic asymmetry between developed and developing countries. This is manifested in the behaviour of interest rates, as investors seek refuge in the assets of developed countries and “flee” the currencies of developing countries. The consequence is that whereas interest rates fall in the former, they rise in the developing world. The current crisis offers the most extreme example of this. Whereas the average country risk of emerging countries increased by some 445 basis points between early June and late December 2008, yields on United States Treasury bills fell by 145 basis points over the same period (see figure 8). Similarly, while the currencies of developing countries are depreciating, those of developed countries are tending to appreciate.

The effects of these developments are fairly obvious. Capital flight, arising in consequence of greater uncertainty, makes it harder to implement countercyclical monetary policies. This does not mean there is no scope for reducing interest rates, given the easing of inflationary pressures and the often excessive increases in these rates during the first nine months of 2008. Meanwhile, the increase in borrowing costs, or the virtual “disappearance” of credit in certain circumstances, is making it far more difficult to apply countercyclical fiscal policies. The situation is quite heterogeneous, however, partly because of policies from the recent past that are unlikely to change under current circumstances.<sup>36</sup> At one extreme is Chile, which is in a position to implement countercyclical fiscal policies thanks to the resources it saved during the period of strong fiscal surpluses, although the country’s current-account deficit ought to be a cause for concern. At the other are Argentina, Ecuador and the Bolivarian Republic of Venezuela

<sup>36</sup> See Gerchunoff (2008).

with a country risk spread of over 1,500 points, which is tantamount to not having access to credit. While other countries are in a position to borrow, they will be doing so at considerably higher rates than in recent years.<sup>37</sup> Opportunities to implement countercyclical fiscal policies will thus be compromised, although the situation will vary from country to country.<sup>38</sup>

### 3. Financing from lending organizations

The absence of an international lender of last resort is more serious than ever in the circumstances described. This being so, the announcement by the Federal Reserve of a liquidity swap line for Brazil and Mexico is a step in the right direction; the real problems will come, however, for countries whose macroeconomic behaviour has been responsible but which will not qualify for special financing because they are not “strategic” for the United States. This is why there is a need for a lender of last resort that can generate incentives to reduce major imbalances and protect the level of economic activity. This will surely be a renewed IMF, which will disburse significant amounts of resources promptly and, in the event of sudden changes in the capital markets, unconditionally, at least in the case of countries that can demonstrate responsible macroeconomic behaviour.<sup>39</sup> Failure to do so promptly would mean that resources which ought to be helping to stem the run on the currency market, preventing sharp devaluations and underpinning demand, i.e., serving as a countercyclical mechanism, could instead end up financing capital flight.

Multilateral support needs to be supplemented by the regional networks that are playing an increasingly important role throughout the world.<sup>40</sup> They are complementary because, while regional networks are much more efficient at providing assistance as and when needed, at least in Latin America, they are unlikely to have the resources they need to finance larger countries at a time of major upheaval.<sup>41</sup>

<sup>37</sup> Brazil and Mexico will also be in a position to take up the US\$ 30 billion liquidity swap facility announced by the Federal Reserve.

<sup>38</sup> A number of countries have already announced countercyclical measures, however. See ECLAC (2009) for a good summary. Their ability to implement what has been announced will be put to the test over the coming months.

<sup>39</sup> Concessional interest rates would be required for middle- to low-income countries. See Griffith-Jones and Ocampo (2008).

<sup>40</sup> See Ocampo (2006).

<sup>41</sup> Machinea and Titelman (2007) discuss ways of boosting regional institutions in Latin America.

Notwithstanding the differences between developing countries in their capacity to implement countercyclical policies, there is something they all have in common with one another and with “recently developed” countries such as the Republic of Korea: since the Asian crisis, these countries have followed a policy of self-insurance involving larger international reserves and the creation of sovereign funds. In line with this, a number of these countries have been running current-account surpluses, which has contributed to the global supply of “lendable” funds. If what is needed now is higher demand to support economic recovery, it is reasonable to think that these countries’ current accounts will weaken, a process that will be accelerated in some of them due

to falling prices for their export products. Thus, not only for structural reasons but also to meet immediate needs, the incentive for self-insurance deriving from the defective workings of the international financial system needs to be removed.<sup>42</sup>

Lastly, returning to the financial needs of 2009 and doubtless 2010 as well, the lack of international financing may condemn the region and particularly its smaller countries to a disproportionate adjustment. Assuming that private lending normalizes to some degree, there is an urgent need for net financing of at least US\$ 70 billion a year (or about US\$ 90 billion gross) from lending organizations or developed countries.<sup>43</sup> The harder credit is to come by, the larger this figure will obviously be.

## VII

### Final reflections

In the years leading up to the crisis that began in 2007 and worsened in 2008, the world economy grew at a rapid rate. It was a period when the financial sector grew on the back of globalization and innovations that helped to expand capital markets, accelerate the creation of new intermediaries and instruments and, crucially, reduce relative capital levels in the finance industry as a whole. It was also a time when the profits of financial intermediaries grew exponentially, swelling from 5% of all profits of firms listed on the New York Stock Exchange in 1980 to 40% in 2007.

This “explosion” in the finance business favoured the growth of certain sectors, particularly durable goods purchases and construction, but it did so—particularly in the last 10 years—at the cost of growing structural weakness. This is not a new phenomenon, as it has happened on many occasions over the last two centuries and especially the last 40 years. In this document we have discussed the main factors behind the crisis, stressing the instability inherent in the financial system, which has intensified in recent years owing to policies of excessive deregulation. We have also argued that the right instrument for correcting the exuberance of the system and its effects on asset markets is not the interest rate, but financial regulations.

We have also considered what might be done to reduce the scale of the recession and ward off the combination of depression and deflation that is threatening the global economy. Developed

countries have a particular responsibility here, not only because they caused the crisis, but also because the problem banks are located within their territories and because they have greater scope for implementing countercyclical policies. As well as speeding up implementation of these measures, there is a need to act as decisively as possible both in applying the fiscal stimulus package and in recapitalizing banks. Delays and “shortfalls” may mean years of recession, compounding future public-sector debt problems. In other words, it would be better to borrow somewhat more now to prevent a prolonged recession that would perpetuate the rising trend in the public debt, as has happened in Japan in recent years.

Where banks are concerned, the options are narrowing in some countries. Unless a permanent solution is found involving temporary nationalization or the purchase of “bad assets”, with all the problems this entails, the option of creating new institutions on the basis of existing banks’ “good assets” and guaranteed deposits is the one that will begin to prevail, with “toxic assets” and unguaranteed liabilities remaining behind

<sup>42</sup> This mechanism will obviously not alter the incentive for China and the Russian Federation to build up international reserves, as these countries’ strategy is guided by other considerations.

<sup>43</sup> The Institute of International Finance expects these organizations to disburse no more than a net US\$ 8 billion in Latin America in 2009.

in the old banks. While the latter alternative has a lower fiscal cost, it would increase the level of uncertainty about banks (or countries) that had not opted for one of the other solutions, so that its overall effects would be difficult to predict.

A few comments apart, this document has not examined the changes needed on the international stage and in national financial systems. With regard to these challenges: aside from altering the incentive system for bank executives, reorganizing the way rating agencies operate to ensure they are truly independent, preventing liabilities other than deposits from exceeding a set amount and increasing the transparency of traded assets, there is a vital need to create countercyclical financial regulation, i.e., to increase capital requirements during upturns and reduce them in recessions. Furthermore, given the enormous capacity of the financial sector for innovation, there is a need to supplement particular capital requirements by risk type with a blanket limit covering all the different varieties of assets.<sup>44</sup> In any event, whatever regulations are put forward in the international sphere will require more input from developing countries, since they cannot be identical for countries with different levels of macro volatility and financial depth and instability.<sup>45</sup>

The economics of countercyclical measures is not simple, since nobody likes to “stop the party”, especially considering that almost all sectors benefit during booms. As the effects of the current crisis are showing, however, when the party does stop, i.e., when boom turns to bust, the costs are not shared in the same way as they were during the years of strong

growth. Lower growth, unemployment and higher taxes particularly affect middle-income and poorer sections of the population. In the face of all these pressures, it is important to construct institutions that can help to implement countercyclical financial policies during booms. Difficult as it may be, now is the time to do it.

The other aspect to stress, once again, is the need to have global and regional safety nets so that developing countries have better prospects of implementing countercyclical policies. This will mean restructuring everything about the IMF from its governance (with a greater presence for developing countries on the board) to credit access (which needs to become more flexible, particularly at times like the present).

The existence of global safety nets would also spare countries the need to self-insure by increasing their international reserves, which limits their willingness to run moderate current-account deficits. Thus, global and regional safety nets will not only make it easier for developing countries to moderate the adjustments required in times of difficulty, but will also help to forestall the kinds of structural imbalances seen in recent years.

Lastly, given that proper regulation of the financial system involves reducing its procyclical tendencies and generally increasing risk capital requirements, it is possible that credit growth may be less in the short term, a small price to pay when set against a less procyclical and more stable financial system and thus stronger credit growth in the medium and long run. Future changes in financial regulation will have to reckon with pressure groups that will soon be inclined to downplay the effects of the crisis or put the blame on other actors. It is also important that these regulations should not hinder financial innovation and, in particular, that efforts to reduce risk do not obstruct the financing of developing countries.

<sup>44</sup> A proposal that meets both requirements is that of Goodhart and Persaud (2008).

<sup>45</sup> See Fanelli (2008).

## ANNEX

### Assumptions used to construct the scenarios

The effects of the global economic recession on the current accounts of the Latin American countries were estimated following the assumptions detailed below, which in a number of cases were constructed using information from the fourth quarter of 2008. For example, remittances fell by about 5% in the fourth quarter of 2008, prior to the large increase in unemployment in the United States, so that two alternatives

were analysed: an 8% and a 15% drop. Where the terms of trade were concerned, eclac assumptions for 2009 were used. For manufacturing exports, the percentage of manufacturing exports under the maquila system was taken, and only value added was imputed to them. In all cases other than the terms of trade, it was assumed that the percentage change relative to 2008 would be the same in all the countries.

**1. Terms of trade:**

Alternative 1: reduction of 12.8% (with a 40% drop in the oil price).

Alternative 2: reduction of 14.2% (50% drop in the oil price).

**2. Manufacturing exports:**

Alternative 1: reduction of 5% by volume.

Alternative 2: reduction of 10% by volume.

**3. Tourism:**

Alternative 1: 10% decline in net revenues.

Alternative 2: 20% decline.

**4. Remittances:**

Alternative 1: 8% reduction.

Alternative 2: 15% reduction.

**5. Investment revenues:**

Considering the drop in returns on mining operations, rents sent abroad were reduced to their level of 2005, a year when export prices for minerals were similar to those forecast for 2009. The exercise was carried out for three countries where this item had seen an extraordinary increase in recent years. The reduction implies a fall of about US\$ 10 billion, US\$ 4 billion and US\$ 3 billion in Chile, Colombia and Peru, respectively.

Regarding financing, the assumptions made for net foreign direct investment were:

a. Alternative 1: 25% decline from 2008.

b. Alternative 2: 35% decline.

(Original: Spanish)

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