On the Roots of the Current Financial Crisis

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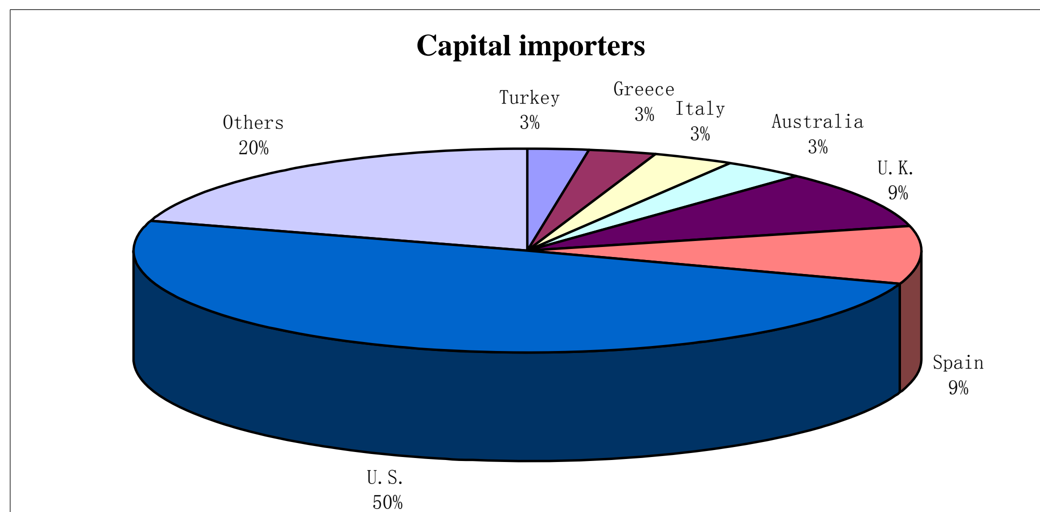
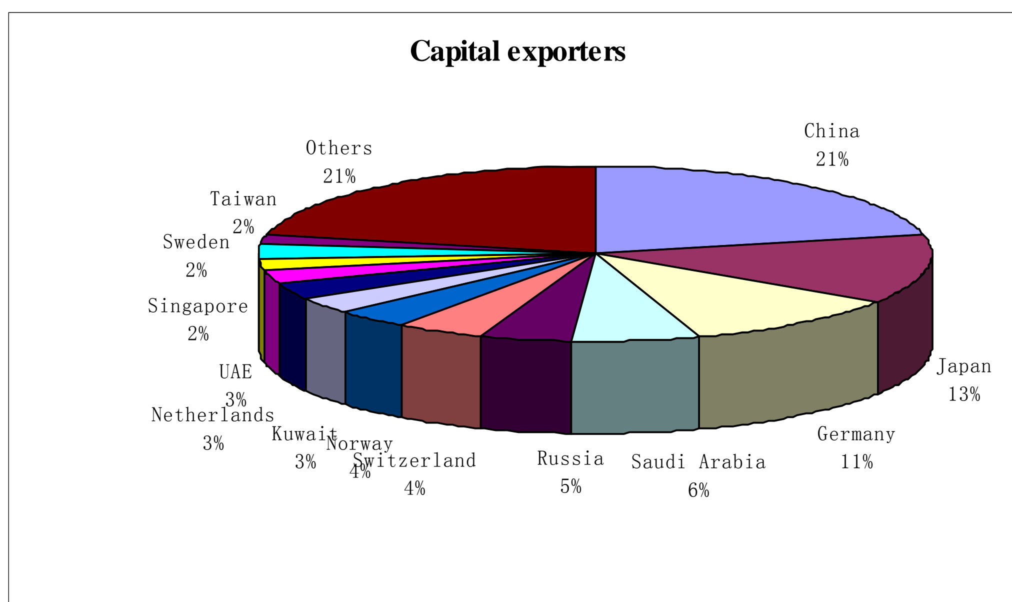
Since the outbreak of the financial crisis, the international community has been in search of the roots of the crisis from the financial regulation perspective and the macroeconomic policy perspective. As a matter of fact, according to discussions at the G20 London Summit, a lot of consensus has been reached on the micro-level causes, including problematic risk pricing of financial products, excessive innovation and lack of financial supervision. However, there are different opinions as for what the macroeconomic triggers could be. The paper is going to explore the roots of the crisis from the perspectives of the international monetary system, growth patterns of countries and their monetary polices, and other macro factors.

1. The financial crisis and the international monetary system

With regard to the global capital flows, the U.S. had been receiving as much as half of the total global inflows before the crisis, while East Asia and oil exporting countries observed a net outflow of capital (IMF, 2008). This, from the perspective of well-accepted economic theories, seems to be a paradox. That is, less developed economies should have been in a real and keen need of capital for development, while they have actually been financing the growth of developed countries with enormous amount of money.

Net capital exporters and importers (2007)





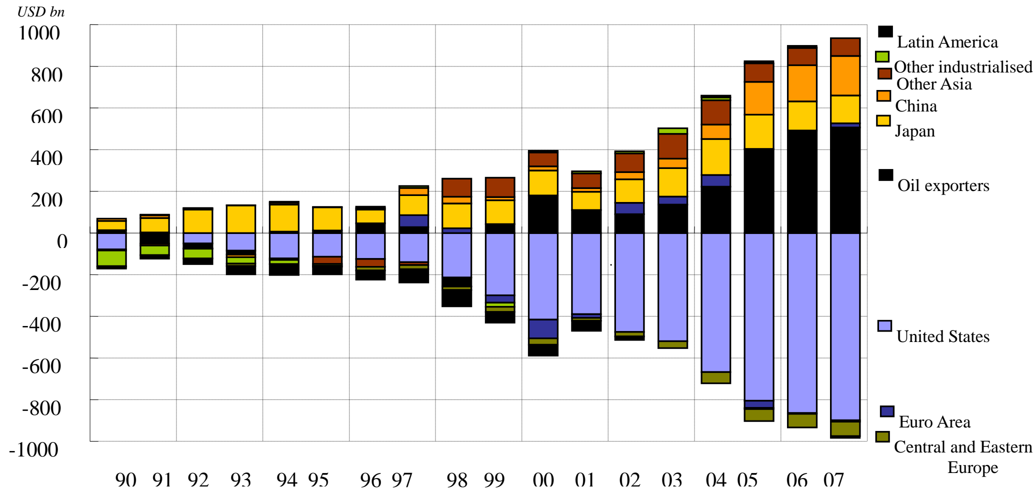
Source: IMF WEO Database

On the surface, the causes of the crisis were related to the pattern of the current global capital flows, over reliance on the relatively advanced financial system in the U.S. and massive purchase of U.S. financial assets. However in essence, the causes of the crisis are closely linked to the flawed international monetary system dominated by the U.S. dollar and U.S. financial asset being the only viable option for U.S. dollar investment. Specifically:

Firstly, in the current international monetary system, countries whose currency serves as the major reserve currency are able to finance their current account deficit by printing money and expanding their balance sheets. On the other hand, emerging market economies have inevitably built up huge trade surpluses and accumulated large piles of assets denominated in major reserve currencies. In fact, the international community did not have effective surveillance over the macroeconomic policies of the reserve currency-issuing countries, the IMF and other international organizations merely focused on surveillance over emerging market economies and developing countries. Drastic fluctuations of the value of the major reserve currencies induced by inappropriate macroeconomic policies of the reserve currency countries normally had no large impact on the reserve currency countries themselves, but wreaked great havoc to financially vulnerable countries especially developing countries.

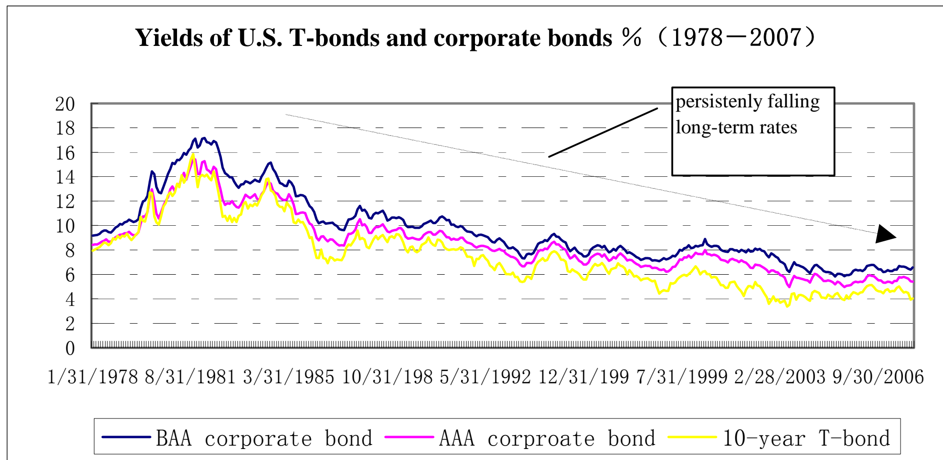
Current account positions: 1990-2007

(In USD billion)



Source: IMF (World Economic Outlook and Direction of Trade Statistics) and ECB staff calculations.

Secondly, due to lack of diversified and effective investment channels, oil exporting countries and some emerging market economies have to invest the bulk of their trade surpluses in dollar assets, with dollar being the main reserve currency. Since 2005, the Fed has been gradually raising its short-term interest rates in a hope to prevent bubbles in longer term. Yet, long-term rates did not rise as a result of the short-term hikes, and Fed's policy intention of pushing up long-term rates was not fully achieved as expected.



Source: Bloomberg; IMF, *Global Financial Stability Report*, April. 2008

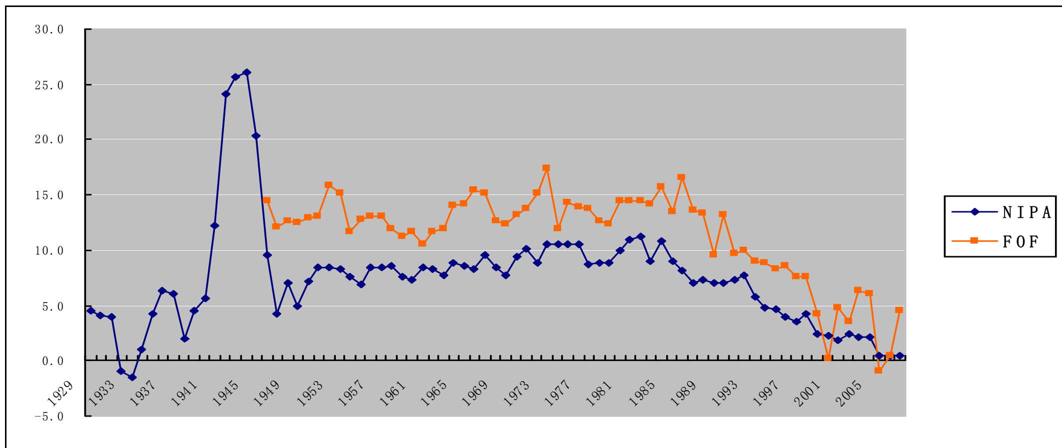
Thirdly, the international monetary system is flawed in terms of its market adjustment mechanism, i.e. capital flows have a positive counter-cyclical effect on the

countries issuing major reserve currencies, but have a negative procyclical impact on developing countries. When an international financial crisis start, a large volume of reserve currencies finds their way back to the U.S. from developing countries and emerging market economies. This helps ease the tight liquidity in the U.S. However, the situation is different in developing countries, where large capital inflow in during good times builds up bubbles, and capital move out in crisis times when it is most needed. Moreover, it is worth noting that, as the dollar is the major pricing currency in international trade and is taken as the benchmark for most other currencies, movements in dollar's exchange rate usually do not have much impact on U.S. exporters. Consequently, dollar exchange rate movements have a rather limited role in rebalancing the U.S. economy. This is also an inevitable result of the flaws in the current international monetary system. Since the collapse of the Bretton Woods system, the world has seen frequent and increasingly severe financial crises. It is reasonable to say that the cost of the current monetary system might have outweighed its benefits. As evidenced by the evolution of the US sub-prime crisis into a full-blown global financial crisis, not only the users of the reserve currency, but also the issuing countries are paying dearly.

2. The financial crisis and economic growth models

The excessively low savings rate in some developed countries and the economic growth model fueled by over-consumption also served as important triggers of the ongoing financial crisis. According to the statistics of U.S. Commerce Department, since 1976, the total expenditure of the U.S. (including private and government sectors) has always surpassed its total income. In the 1970s, the average overdraft rate was 0.2 percent, which surged to more than 5.7 percent in 2006 at the eve of the ongoing financial crisis. Rapid expansion of consumer spending reduced savings in the U.S. and led to a widening gap between investment and savings. The U.S. economy did not run a savings gap between 1929 and 1969, but was on a gap of 4.3 percent between 2000 and 2007, represented by an increasingly large trade and current account deficit.

Personal Savings Rates as a Percentage of Disposable Personal Income (1927-2007): Comparison of National Income and Product Accounts and Flow of Funds Accounts



Source: U.S.Department of Commerce, Bureau of Economic Analysis.

The U.S. growth model featuring low saving and high consumption is closely related to its macroeconomic policies and other factors. Specifically, prolonged loose macroeconomic policies have stimulated the expansion of public expenditures and household consumption and has continuously driving down the savings rate; lax financial regulatory policies have spurred massive financial innovation and provided incentives for consumption on credit, which fueled excessive borrowing and pushed down savings rate of the household sector, and thus brewed huge risks. Moreover, the international monetary system dominated by particular reserve currencies, has facilitated this growth pattern. With the collapse of the Bretton Woods system and the delink of dollar from gold, there is no longer any ceiling on the volume of dollar issuance. As a result, the U.S., as a major currency issuer, is able to gain free access to low cost borrowing in the international financial markets through bond issuance, which further fed its growth model featuring high consumption and low saving.

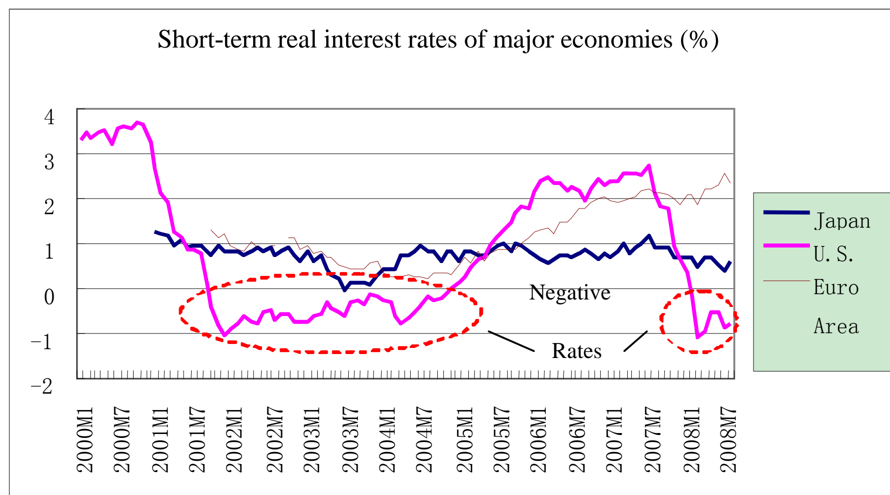
Some also hold the view that, the unreasonable growth model of the U.S. can be partly attributed to the euphoria attitude towards American economy since mid-1990s. In late 1980s and early 1990s, after the collapse of the central planning system of the former Soviet Union and Eastern Europe, growth in those regions slipped. In the 1990s, the Japanese economy was in prolonged stagnation, and EU's economic performance was lackluster due to structural problems including rigid labor market. The U.S., as the largest economy, with a flexible economic system that was seemingly unparalleled in the world, faced only one challenge, in terms of economic system, from East Asia. Yet after 1997, the Asian economies suffered from a financial crisis. In contrast, the US economy displayed flexibility and resilience, and recovered rapidly from the 9.11 attack and the burst of IT bubbles in recent years. All these augmented an euphoria sentiment in the market, which in turn influenced the saving and consumption behaviors of the U.S. residents. However, the unprecedented magnitude of the current financial crisis is expected to dramatically dampen such euphoria sentiments. It is noteworthy that, in time horizon the high surplus in southeastern Asia and the low savings rate in the U.S. were not synchronized, and there is no causal relationship between the two. It is illogical to attribute the ongoing

financial crisis and the growth model featuring excessive overdraft of some developed countries to exchange rate issues of the developing countries.

3. The financial crisis and monetary policy

Theoretically, one can examine to what degree monetary policies were loose in the run-up to the crisis by using the following two approaches.:

Firstly, measuring by the real interest rates after allowing for price factors, real short-term interest rates in major developed economies were at historical low levels between 2001 and 2005. In particular, interest rates in the U.S. were negative for a long time, indicating low financing cost during that period.

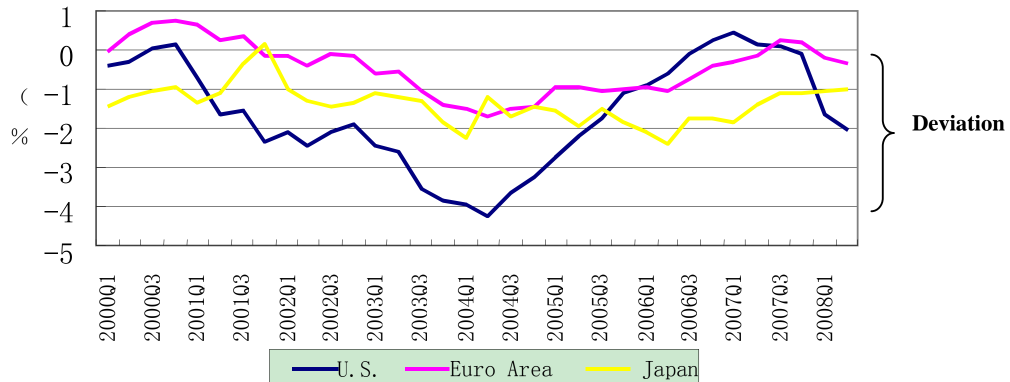


Source：Bloomberg and IMF WEO Database。

Note：The short-term real interest rate is the core inflation-adjusted 3-month T-bond interest rate.

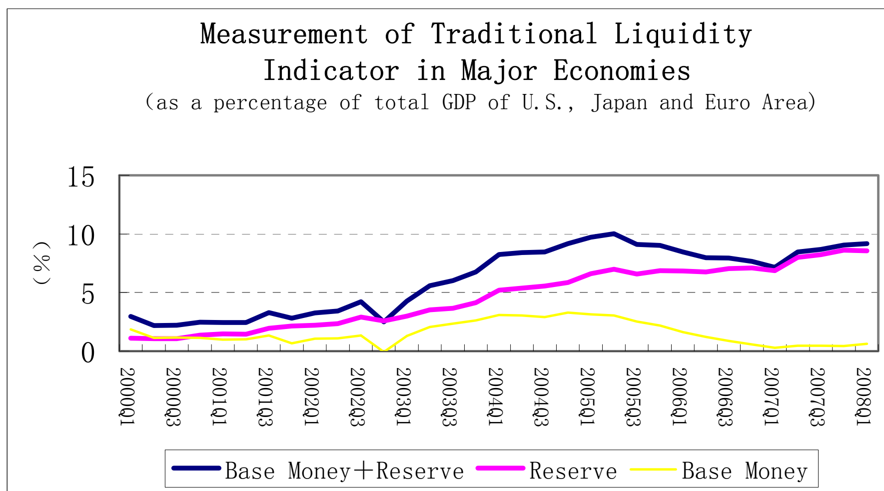
Secondly, the monetary policies of major western economies were quite loose between 2001 and 2006, measured by the deviation from the Taylor Rule. An approximate but simple gauge of the deviation of monetary policy is the currency gap, which is the gap between short-term interest rates and the base interest rates calculated according to the Taylor Rule. It is found out that, between 2001 and 2006, the short-term interest rates of major developed economies, especially the U.S. were significantly lower than the level derived from the Taylor Rule.

Deviation from Taylor Rule



Source：______, Having Macroeconomic Policies Been Too Loose? IMF, *World Economic Outlook*, October. 2008.

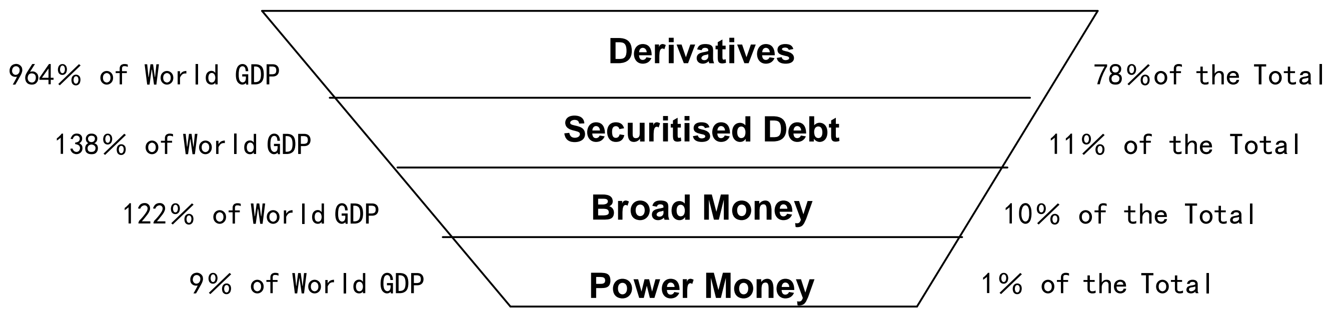
Before the crisis, there were lots of discussions on over supply of global liquidity. First of all, traditional liquidity indicators (base money, reserve, and etc.) grew rapidly in the run-up to the crisis.



Source: Bloomberg, IMF WEO Database。

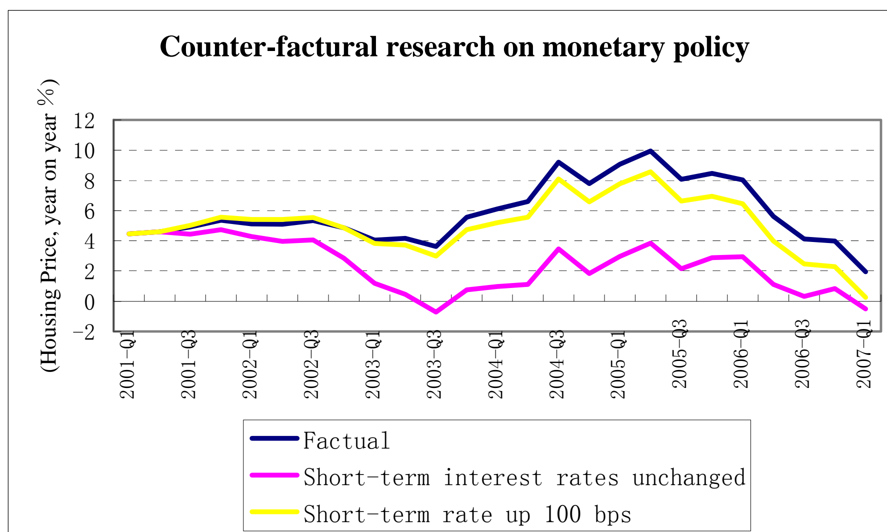
Moreover, with frequent financial innovations and the subsequent mushrooming of securitized products and derivative instruments, many market participants regarded these as part of the "broad liquidity" created by the shadow banking system[1]. This has expanded the scope of traditional liquidity. It was estimated that 78 percent of the broad liquidity was liquidity created by derivative instruments, and it was 9.64 times the world GDP. Meanwhile, a mere 10 percent of the broad liquidity fell in the category of M2, and it was 1.22 times the world GDP (Bollard, 2007). Such broad liquidity was beyond the direct control of monetary authorities.

[1] Shadow banking system includes broker-dealers, hedge funds, private equity groups, structured investment instruments and channels, money market fund, and non-bank mortgage lenders.



Source: Independent Strategy; Alan Bollard: Easy Money - Global Liquidity and Its Impact on New Zealand，BIS Review, No.25,2007.

Low interest rates and overly optimistic sentiments spurred investment in riskier assets. In the absence of adequate financial regulation, this caused financial institutions to increase their leverage ratio and scaled up their liabilities, pushing up the price of financial assets and their derivatives in the international market. An empirical study on Federal Reserve's monetary policies since Greenspan took office (Bordo and Jeanne, 2002) shows that, the federal funds rate was set based on inflation and aggregate demand. The Fed did not use federal funds rate to curb the over-pricing of assets. On the contrary, the Fed seemed to have a let-it-be attitude towards it until the burst of asset bubbles. A recent counter-factual research by the IMF shows that had the Fed not adopted a low interest rate policy, the real estate bubbles would have been contained to a certain extent. In retrospect, this has not received adequte attention from major central banks.



Source: Independent Strategy; Alan Bollard: Easy Money - Global Liquidity and Its Impact on New Zealand，BIS Review, No.25,2007.

4. Conclusion

In conclusion, the outburst of the ongoing financial crisis is closely related with the flaws in the current international monetary system, growth pattern of some advanced economies and their macroeconomic policy choices. It is not realistic to expect the long-standing features that have lead to the crisis to change in the short term. A broader perspective should be adopted and comprehensive measures are needed to respond to the crisis. If fundamental issues including the international monetary system and the route of flowing back of dollars are not resolved, there may be a reoccurrence of the 2005 asset bubbles and even a repetition of the current crisis, even after Federal Reserve adopt exit arrangements after the crisis is over to withdraw the enormous liquidity injected during the crisis period, since global savings will flow back to dollar-denominated assets and it will be difficult for the stabilizing policies adopted by the U.S. to meet their goals.

One lesson from the crisis is that study should be made on how to reform and improve the current international monetary system. First of all, the international community should not overlook the risks arising from the international monetary system and pay adequate attention to surveillance over the countries that issue the world's major currencies. Secondly, the role of special drawing rights (SDR) should be enhanced. In the long run, efforts are needed to promote diversification of the international monetary system. Moreover, since the developing countries lack the necessary fund to increase investment and consumption, considerations can be to setting up a "supra-sovereign wealth investment fund" to help channel capital inflow into developing world so that these countries can serve as new engines in global recovery and growth. Last but not least, although this crisis has not in effect altered the traditional monetary policy objectives, policy makers may need a broader perspective, give more considerations to the potential impact of movements of asset prices, leverage ratio and capital flow on their traditional objectives, adopt more flexible means to respond to excessive asset price movements and drastic changes in broad liquidity.

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