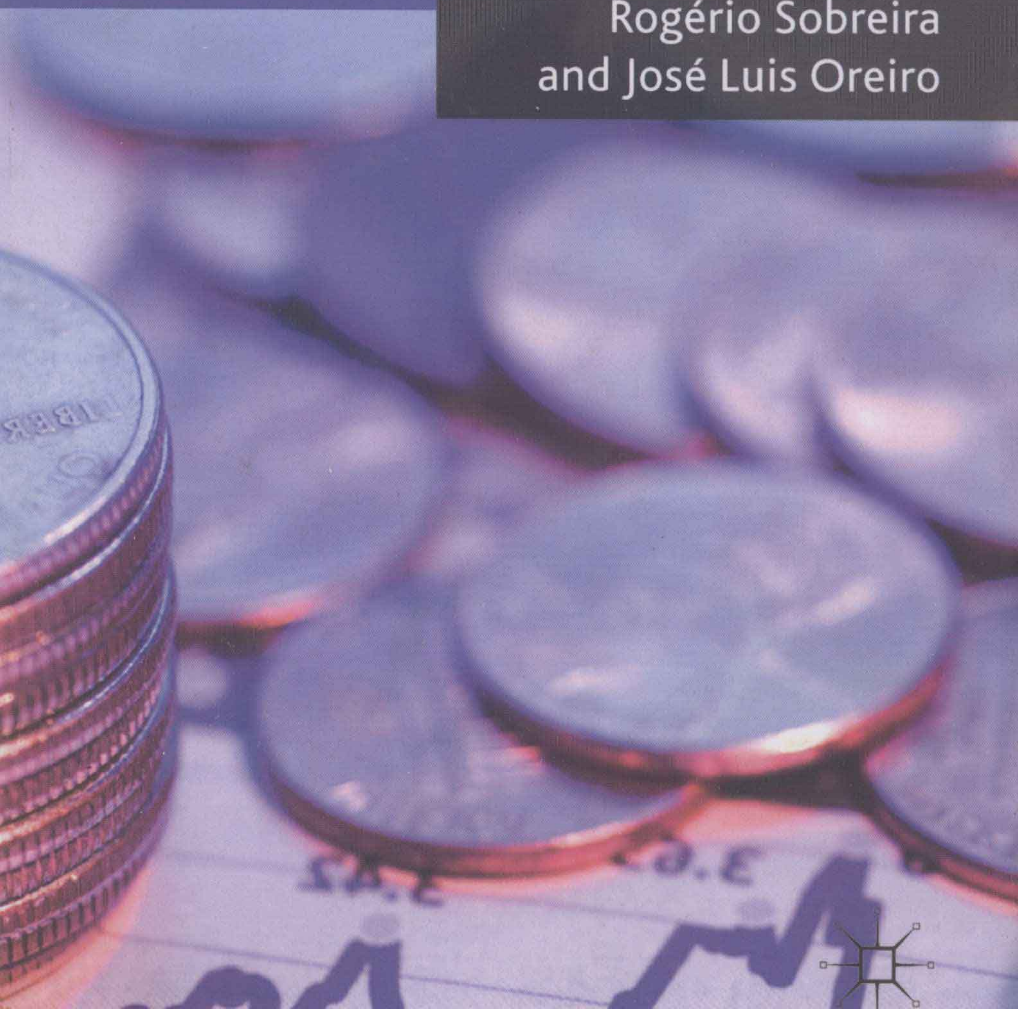
The Financial Crisis

Origins and Implications

Edited by Philip Arestis,
Rogério Sobreira
and José Luis Oreiro



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Contents

List of Tables and Figures

Tables

Figures

1
Introduction

Philip Arestis, Rogério Sobreira and José Luis Oreiro

The recent financial crisis was the biggest economic crisis of capitalism since the Great Depression of 1929. Starting in the United States after the collapse of a speculative bubble in the housing market fuelled by a massive credit expansion caused by the utilisation of new financial instruments (the subprime loans, securitisation, derivatives and so on), the financial crisis spread all over the world in just a few months. The triggering event of the crisis was the bankruptcy of Lehman Brothers on 15 September 2008 after the Federal Reserve (Fed) refused to bail it out. This decision had a tremendous impact over the state of expectations in financial markets, since there had been a general belief that the Fed would continue to bail out financial institutions affected by the collapse of the speculative bubble in the housing market. After that, it was no longer possible to believe that the Fed would always rescue financial institutions that are considered 'too big to fail'. The result of this change in the state of expectations was the emergence of panic between financial institutions that resulted in a huge increase in their liquidity preference, mainly by commercial banks, producing a sharp decline in asset prices and in the supply of credit for almost every type of commercial and industrial transaction. The 'credit evaporation' resulted in a very rapid and deep decrease in industrial production and in the international trade all over the world (see Table 1.1). In the last quarter of 2008, industrial production and GDP of developed countries experienced a huge fall, in some cases the annualised rate of GDP contraction was greater than 10 per cent. Even developing countries that do not have problems with their financial system, such as Brazil, had observed a tremendous reduction in industrial production and GDP. In Brazil, for instance, industrial production fell by almost 30 per cent in the last quarter of 2008 and GDP had fallen at an annualised rate of 11 per cent during this period (Table 1.2).

Table 1.1 Industrial production: percentage change over previous year (monthly data)

Industrial Production – percentage change from same period prev. year				
Country	**2008 M10**	**2008 M11**	**2008 M12**	**2009 M01**
Brazil	0.2	–5.4	–16.4	–15.3
Canada	–6.1	–8.2	–7.8	–11.3
France	–7	–8.8	–10.4	–15.1
Germany	–3.5	–7.5	–12.3	–20.2
Italy	–8.5	–10.5	–13	–17.5
Japan	–8.3	–13.7	–21.2	–28.9
Spain	–14.6	–15.7	–19.7	–20
United Kingdom	–6.3	–8.3	–9.7	–12.2
United States	–4.7	–6.5	–8.9	–10.9

Source: Joint IMF–OECD Statistics, 30 March 2010. M stands for relevant month; *World Economic Outlook*, October 2009.

Table 1.2 Gross Domestic Production: Percentage change over previous quarter (quarterly data)

GDP – A quarterly percent change				
Country	**2008 Q2**	**2008 Q3**	**2009 Q1**	**2009 Q2**
Brazil	1.1	–2.92	–0.88	1.08
Canada	0.1	–0.95	–1.79	–0.87
France	–0.2	–1.5	–1.3	0.3
Germany	–0.32	–2.44	–3.52	0.44
Italy	–0.87	–2.18	–2.71	–0.49
Japan	–1.3	–2.7	–3.6	1.5
Spain	–0.55	–1.08	–1.7	–0.96
United Kingdom	–0.93	–1.8	–2.61	–0.69
United States	–2.7	–5.4	–6.4	–0.7

Source: Reuters Statistics, 30 March 2010. Q stands for relevant quarter.

Governments in developed countries responded to this crisis by means of monetary and fiscal policy expansions. The Fed reduced the short-term interest rate – the Fed funds rate – to almost 0 per cent and increased its balance sheet almost three times in order to provide liquidity to financial markets in the US. Similar policies were adopted by the European Central Bank and the Bank of Japan. In the US, the new president, Barack Obama, managed to approve a fiscal expansion of almost $800 billion to increase aggregate demand and boost the US economy. In the euro area, governments were allowed to increase the fiscal deficit beyond the tight limits of the Maastricht Treaty in order to help an economic recovery. Similar efforts were undertaken in the UK and elsewhere, including in some developing countries. In China the government, for instance, increased expenditure in public investment – mainly infrastructure – by more than $500 billion in order to maintain the economy's high growth path. In Brazil fiscal policy expansion began earlier than monetary policy expansion due to an irrational commitment by the Brazilian government to a very tight inflation-targeting regime. The Lula administration approved a fiscal stimulus package at the end of 2008, comprising increases in public investment, reductions in tax and increases in the value of unemployment benefits and the minimum wage. The reduction in interest rates began only in January 2009 after a huge collapse of industrial production at the end of 2008 and widespread rumours about the replacement of the president of the Central Bank of Brazil. As a consequence of that delay in easing monetary policy, GDP growth fell from 5.1 per cent in 2008 to –0.7 per cent in 2009 (IMF, 2009, p. 85).

The economic consequences of the 2008 crisis will be long-lasting. In 2009 the main industrial economies witnessed huge falls in GDP. In fact, the US had a fall in GDP of 2.7 per cent, the euro area a fall of 4.2 per cent, Japan had a fall of 5.4 per cent and the UK a fall of 4.4 per cent (IMF, 2009, p. 69). For 2010, the IMF projections were for a slow recovery for the US and Japan, and a near stagnation for the euro area and the UK. This means that GDP level pre-crisis will not be reached before the end of 2011 or the beginning of 2012 despite the substantial fiscal and monetary stimuli.

Despite the huge fall in industrial production and GDP in both developed and developing countries, the severity of the 2008 financial crisis was very far from the catastrophic outcomes observed during the 1930s. At the end of 2009, the US economy began to show positive signs of recovery, signalling a modest growth for 2010. France and Germany exited from 'technical recession' in the middle of 2009 and the same occurred for the UK in the last quarter of the same year. During the crisis developing countries had a much better average economic performance than developed countries. GDP growth in China was 8.5 per cent in 2009, showing a very small reduction compared to 2008 when its economy had grown at a rate of 9 per cent (IMF, 2009, p. 74). The economic performance of India was also good. After a GDP growth of 7.3 per cent in 2008, economic growth had fallen to 5.4 per cent in

2009. For 2010, IMF projections show a GDP growth of 5.4 per cent for India. Brazil's economic performance during the crisis was not as good as that observed in China and India. After a robust GDP growth of 5.1 per cent in 2008, GDP fell by 0.7 per cent in 2009. However, growth is expected to resume in 2010 to a rate of 7.0 per cent (Ministry of Finance, 2010). Among the larger developing economies, only Russia showed a substantial decrease in GDP. According to the IMF, GDP in Russia fell by 7.5 per cent in 2009 after experiencing positive growth of 5.6 per cent in 2008. For 2010, the expected growth rate for Russia is about 1.5 per cent.

The intensity of the 2008 financial crisis poses three fundamental questions for economists and policymakers. The first relates to the origins of the crisis; the second is concerned with the consequences of this crisis for the world economy; and the third question is about what did not happen – namely, why did the 2008 financial crisis not cause a catastrophic fall of GDP as witnessed the 1929 crisis?

Regarding the first question there is a widespread opinion that the 2008 financial crisis was solely the result of inadequate financial regulation together with a very loose monetary policy conducted by the Federal Reserve during Greenspan's term. If that is so, there is no need to reform the international monetary system or to worry about the pattern of income distribution in developed economies. A restricted change of financial regulation and a redefinition of inflation targeting in order to include the stabilisation of asset prices as one of the goals of monetary policy will be enough to avoid financial crisis in the future.

In respect of the second question, there is a widespread opinion that this crisis was only a temporary detour from the normal course of events, so that in the near future capitalist economies will resume the high growth path observed before the crisis. Growth could again be led by credit expansion in the US and economic policy can be conducted in a similar way as it had been before the crisis.

In terms of the third question, there is a widespread view that the fundamental reason that explains the avoidance of the harmful experiences of 1929 was the fiscal and monetary policy expansions in developed countries. No important role is assigned to developing countries in terms of the effects of the August 2007 financial crisis.

This book will present a challenge to these views about the origins and the consequences of the August 2007 financial crisis. A common unifying element of the chapters in the book is the view that in order to avoid a new financial crisis in the future what is required is not only a profound change in the financial regulation but also a change in the