THE 2007 CREDIT CRISIS: A LONG-TERM VIEW

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Abstract

It is fair to say that the 2007 Credit Crisis was born a year ago, in August 2007. Since its onset, economists and finance experts have been conjecturing whether as a result, the world economy will be moving into a depression and at what final cost? By the end of 2007, the United States and other Western economies have already been entrapped in the complex dynamics and negative externalities of the Credit Crisis. However, the extent of the crisis effects, if not its end, is not clearly in sight, while the solutions presented have focused on the short-term, that more often than not bail-out the guilty, thus encouraging moral hazard that leads to a repeat of the crisis. But if this is the case, then the onset of the Crisis must have been twenty years earlier, at the time of the Savings and Loan Crisis of the late 80s that was followed by the Tech Bubble of the late 90s. This article focuses on the economic and sociopolitical forces that brought about the 2007 Credit Crisis and explore its consequences. It investigates how the Western banking systems, including their central banks, reached the present messy situation with its negative local and global consequences? The article focuses on three factors that seem to be behind the rise of the present financial crisis and its reoccurrence with increasing negative outcomes. The first factor is the weakness if not the perplexity of the present regulatory mechanism, both technically and politically that let lenders ignore basic rules and regulations, locally and globally. There is a need for an independent International Financial Regulation Authority (IFRA). The second factor is the lack of understanding of the regulatory environment and its dynamics and negative externalities of the Credit Crisis. However, the extent of the crisis effects, if not its end, is not clearly in sight, while the solutions presented have focused on the short-term, that more often than not bail-out the guilty, thus encouraging moral hazard that leads to a repeat of the crisis. The third factor is the pressure of the political system for short term and biased solutions that degenerate the ethical system. The political system for short term and biased solutions that degenerate the ethical system. The political system for short term and biased solutions that degenerate the ethical system. The second factor is the need for more comprehension and anticipation of the role of Globalization in the processes of global finance and development. The 2007 credit crisis provides important lessons for financial development and control in the ERF region and the rest of the world.
Introduction

It is fair to say that the 2007 Credit Crisis was born a year ago, in August 2007. Since its onset, economists and finance experts have been conjecturing whether as a result, the world economy will be moving into a depression and at what final cost\(^1\)? By the end of 2007, the United States and other Western economies have already been entrapped in the complex dynamics and negative externalities of the Credit Crisis. For example, in the year since August 9\(^{th}\) 2007, the 5-trillion mortgage empire of the top two mortgage houses, Fannie Mae and Freddie Mac was threatened and required the largest bailout in the history of the US treasury, while the largest ten international banks, with available data, reported heavy write-downs and losses totaling about $300 billion, which is blamed partly on inadequate management—many CEO’s of the mortgage houses and these banks were fired as a result\(^2\).

But the crisis is more than bad management. It is the outcome of increasingly complex global techno-economic and financial systems that lacked adequate regulation. In the past few decades, the financial system has illustrated that “markets are so interconnected and so global that the poison can spread across markets and continents with terrifying speed” (The Economist, 2007). Meanwhile the poison may accumulate undetected for years in the concealed alleys of the global system before it bursts into serious financial and economic crises. Answers to the question, of whether depression is knocking on the doors of Western economies have been mostly in the affirmative. But, now a year after the crisis erupted in mid 2007, the extent of its consequences, if not its end, is not clearly in sight. This article focuses on the economic and sociopolitical forces that brought about the Crisis and explore its consequences.

In late 2007, Paul Samuelson\(^3\) had an answer to that question. Depression, he reasoned, is knocking on the doors of the USA and other Western economies. He recounts that “All through the years of the Great Depression, Wall Street publicists and President Herbert Hoover would repeatedly declare: "Recovery is just around the corner." They were wrong. And history repeats itself. Today, Federal Reserve Chairman Ben Bernanke admits that nobody, including him, is able to guess how near to bankruptcy the biggest banks in New York, London, Frankfort and Tokyo might be as a result of the real estate crisis.”

The Economist (2007 \textit{ibid}) basically agreed with Samuelson. The crisis is contributing to broader economic weakness that is leading to depression. Other views and events gave support to that conclusion. For example, a recent study by the Bank of International Settlements concluded that “Further deterioration in the US housing market and concerns about associated economic and financial risks continued to take centre. … Uncertainties about subprime [weak borrowers] and other credit market exposures remained, adding to more general concerns that US housing market woes would deepen and eventually contribute to broader economic weakness. With market participants refocusing on these risks and liquidity conditions in money markets remaining tense … Against this background, and with oil prices surging to new highs, share prices fell

\(^{1}\) Cost estimates are in the trillion dollar range. Meanwhile, the US government is requesting Congress to allocate a $700 billion budget to deal with the Crisis, and raising the statutory national debt limit to $11.3 trillion.

\(^{2}\) The losses of the ten largest banks for which data was available were: Citigroup (54.68bn), Merrill Lynch (51.85bn), UBS (38.28bn), HSBC (27.48bn), Wachovia (22.08bn), Bank of America (21.28bn), IKB 15.98bn), Royal Bank of Scotland (15.21bn), Washington Mutual (14.85bn), and Morgan Stanley (14.48bn). Source: Bloomberg, Thompson Data Stream and Company Reports. Half the banks listed above, fired their CEOs since the crisis erupted (The Economist 2008B: 71), also the top executives of Fannie and Freddie, the two top mortgage houses were ousted, all with high compensation.

\(^{3}\) Samuelson 2007, Noble Laurite
sharply in major equity markets. The financial sector was particularly badly hit, following a string of multibillion dollar credit-related writedowns by banks.

Authorities also agree that the emerging financial structures, especially the complex newfangled securities discussed later in the context of hedge funds, combined with weakened regulation and an evident change in market ethics, are mainly responsible for the emerging Credit Crises. For example, Samuelson indicated that the newfangled securities played a negative role in the crisis when he said, “As one of the economists who helped create today's newfangled securities, I must plead guilty: These new mechanisms both mask transparency and tempt to rash over-leveraging.” (Samuelson, 2007).

However, Samuelson neither stated with clarity the role these securities played in the credit crisis, nor indicated the policies required to end their negative effects. His solutions were based on old recipes borrowed from the depression era and 19th century advice of Bagehot: lend freely when depression threatens. But these remedial recipes are short-term solutions, and they may not work for the present crisis, since there were no newfangled securities to emulate in these eras. Furthermore, it is an axiom of regulation that bailing-out the guilty encourages moral hazard which in turn leads to a repeat of the crisis. Evidently, there has been a repeat of crises in the past two decades with cost escalating overtime: the Savings and Loan Crisis of the late 80s followed by the Tech Bubble of the late 90s, up to the present Credit Crisis of the late 2007—the onset of the Credit Crisis should be twenty years earlier! Probably Samuelson underestimated the complexity of the securities he helped create: their ability to conceal transparency, the nature of their volatility, contagious spread, and their negative long-term consequences.

On the other hand, The Economist report, although it highlighted the negative role of the newfangled securities in the crisis, it also ignored how to control its consequences. Instead, it focused more on the role of an ancient politic-ethic paradigm in generating the crisis. The paradigm assumes the presence of political pressures that influence, if not prejudice, Central Banks’ actions. Apparently, such influence has been the case in the present crisis. It evidently lead decision makers to self-doubt, confused ethics and reduced the use of scientific analysis in the decision making process. But scientific analysis, according to the Economist, has not been used methodically by central banks. The science of Central Banks according to the Economist “(Is) an imperfect science and there are disagreements about what to target and how. Moreover, central banks make mistakes, as the Fed did in allowing the housing bubble to inflate. The extraordinary pace of financial innovations and globalization has been a nagging source of self-doubt. Perhaps the most troubling lesson, however, was not economic or supervisory but political … Mr. Bernanke at the Fed came under huge political pressure to cut interest rates … The hope in the financial market is that the worst of the credit crisis is now past.” (The Economist ibid: 38, emphasis added)

Although in its conclusions, the Economist did not provide preventive measures to stop the negative role of these financial novelties, it brought to light the role of politics and ethics in the credit crises, thus widening the scope of investigation. Psychologists and behavioral economists have debated for years the relation of human rationality to fairness. Rationality

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5 The relation of ethics and politics to human action and behavior is not new. The debate as to its role in human action goes back as far as Aristotle. Many Christian moralists believe that virtuous actions (ethics) are higher than the consequences of its applications (politics)—politics should not override virtue (cf. Russell 1971945: 178-9). The paradigm raises a basic question relevant to the credit crisis: Is the remedial ‘good’ belongs to society as a whole, or the ‘good’ is contingent on its content of justice, and especially its non-discriminatory distribution? Politics may aim for the ‘good’. But the ‘good’ may only benefit the few, a benefit that may exceed the total suffering of the many. This is an ethical question that requires emphasis.
implies self-maximizing and efficiency while fairness is viewed as opposed to rationality (for example psychological fairness versus profit). But some researchers see that the “moral sense of fairness is hard wired into our brains and is an emotion shared by most people and primates tested for it.” They believe that “Don’t Be Evil” as a model of business is the rule in market behavior, while the “Greed Is Good” model is the exception. Since, if the latter behavior is the rule, “market capitalism would have imploded long ago,” (Shermer 2008: 36). But “Greed Is Good” has been the moral code of market behavior during the past three decades. This is illustrated by Krugman analysis of income and wealth distribution in the United States. Krugman found an unprecedented rise of inequality in income and wealth during the past three decades: a minute group, with enormous and ever-increasing wealth and power was able to overpower the ethical model of the vast majority. Yet Krugman could not find any economic rational to explain the rise. He had to resort to change in values and the ethical system, as the likely cause (see Krugman 2000 and Sirageldin 2007 for more details).

**Background**

The origin and rise of the newfangled securities is the outcome of a major change in the structure of international finance that took place almost four decades ago — on August 15, 1971 to be exact. On that day President Richard Nixon instructed the US Secretary of the Treasury to suspend all sales and purchases of gold:

“The gold window was closed. It has never reopened, and the international economy has never been the same.” (Eatwell and Taylor: 1)

Nixon’s decision marked the beginning of the end of the Britton Woods system and the beginning of a global open financial structure that proved to be complex and open to new financial initiatives that are difficult to regulate.

Three decades later, Eatwell and Taylor (*ibid*) emphasized that the evolving financial markets are not self-regulating. In periods of innovations and deregulation, authorities tend to lose control of credit allocation while the financial markets being free to choose, a freedom that did not lead to system equilibrium or optimality. The result has been a frequent breakdown of national regulatory capacities especially as financial liberalization took hold, and spread worldwide. Examples of breakdowns are plenty: the case of the 1980’s Japanese “bubble economy”, the 1990’s British house-price boom, the 1997 Asian currency crisis, the Russian default of 1998, and the United States’ 3-trillion dollar crises of the past two decades mentioned above, with remedies that created a system of moral hazard.

Meanwhile, the consequences of breakdowns have been devastating. They include massive economic upheavals even for the integrated financial markets of industrialized economies, the presence of waves of currency crises, the lack of fundamentals in determining exchange rates, the lack of transparency in transactions, the adverse distributions of penalties and rewards that do not reduce negative outcomes in the longer term, and the increasing play of the politic-ethic paradigm mentioned above. In such chaotic atmosphere, speculative activities may not only lead to financial market stability, but the atmosphere itself tends to produce a mode of ethics that put profit margins above system stability if not viability. Evidently, the emerging speculation tends to thrive in the midst of instability. It is not surprising that the growth of newfangled securities with their built-in speculative tendencies paralleled an evident decline in Central Banks’ regulations and controls.

Initially, these newfangled securities were created from all sorts of financial assets. These securities, although mostly unregulated by the financial authorities, could be bought and sold freely in the global financial market. To lure buyers, newfangled securities are stamped with rating stars based on complex mathematical formulas. However, the purpose of luring buyers was not for the benefit of buyers as much as for protecting initial lenders from the risk of
default. But some rating agencies combined the role of ‘rating’ with that of advising buyers and sellers, thus generating evident conflict, confusion and lack of transparency in system dealings that made the whole rating mechanism disreputable, and branded their conduct as outright deception:

"By divorcing lenders from the risk of default, securitization reduced their incentive to look carefully at their borrowers: at times one side or the other, or both, descended to outright fraud. And no one, least of all financial regulators, could be quite sure who in the global financial system was on the hook for which risks." (The Economist, 2007: 4)

As mentioned above, all types of financial assets, loans, mortgages, interest payments, default risk and who knows what else have been converted into new highly diversified securities that are being sold and resold in a trillion-dollar global market place. As a result of this enormous and highly dynamic market with sales and re-sales being made at lightning speed, many of these securities traded outside the jurisdiction of existing regulatory institutions. This flexible rule that does not allow US federal banking regulators to oversee non-deposit-taking institutions such as the case with Fannie and Freddie along with the increasing connectivity in the global market place, and the inherent complexity of the securities themselves, forced the present supervisory and regulatory institutions to lose effectiveness, if not total control, of the financial system. To illustrate this point, hedge funds, viewed as mutual funds of the rich, are basically unregulated. Although similar to mutual funds in that investments are pooled and professionally managed, they differ in that hedge funds have far more flexibility in their investment strategies, which makes it inaccurate to say that hedge funds just “hedge risk”. Actually hedge funds make large speculative investments that can carry more risk than that of the overall market. But because of their limited-access and the status of its private nature, they are allowed to function outside the supervisory jurisdiction; they are not compelled to register with the US Securities and Exchange Commission (SEC) despite the fact that their negative consequences and financial weight affect the inter-bank system, an influence that is a short step from Fed finance. However, that short step was bridged twice, in 1998 and 2008. In 1998, the famous episode of Long Term occurred. It lost half its assets in one month, thus obliging the Federal Reserve Bank to arrange for a controversial bailout package totaling 3.5 billion dollars. Evidently, the bailout produced a moral hazard effect. Ten years later, in 2008 the episode repeated itself (to use Samuelson’s statement), with failure rates soaring to three quarter of the 2008 Hedge Fund industry of $600 billion. The result is scramble bailout operations rather than a serious attempt to set better management rules for the industry (cf. Investment News, September 5, 2008, “As Failure Rate Soars, Hedge Funds Bailout”).

Thus, between complex and unregulated newfangled securities such as hedge funds, and giant mortgage companies such as Fannie Mae and Freddie Mac, Central Banks are bound to lose control, especially in the context of an open global finance market.

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6 For more details about the structure of a Hedge Fund, the reader may refer to Investopedia, a Forbes Media Company or Wikipedia, the Free Encyclopedia.

7 Long Term started in 1994 by John Merriweather, former vice President of Salomon Brothers and 15 other partners including economists Myron Scholes and Robert Merton who won the Nobel Prize for the development of the securities based on complex mathematical formulas, with the expectation of producing global financial stability. Long Term however, ended with the largest market loss. It lost 2 billion dollars in one month alone — almost half of its total assets at the time. It tried unsuccessfully to recoup its losses with more than 100 billion dollars in risky bond market investments. Almost half of the Hedge Funds did not earn the performance fees in 1998—mostly liquidated and started anew. [Kwame Holman, Risky Business, October 01, 1998; thanks to Kamal Sirageldin for suggesting the historical comparison].
The Weakening of Regulation and Supervision

As the complexity of the system increased and its scope spread globally at intensified speed, central bankers become more aware of their limited supervisory powers and lack of knowledge about the changing dynamics of local and global economies, especially their interface. Donald Khon, a Fed governor, stated the situation with admirable honesty:

“In informal terms, we are uncertain about where the economy has been, where it is now and where it is going.” (Quoted in The Economist 2007, ibid: 6).

No wonder that even experts were perplexed, not only about how to manage the financial system, but more basically, about how to define what is to be managed. To illustrate, the 2007 Credit Crisis has been called a subprime crisis (weak borrowers), a banking crisis, a crisis of liquidity, a crisis of collateral, a crisis of central banking, as well as a globalization crisis. Such a varied use of definition is expected in a system that is extremely interconnected. But as a result, the need for effective supervision intensifies, since as complexity increases, the frequency of system breakdowns also increase. But effective supervision requires better understanding of the evolving system and the emerging role of the newfangled securities. However, tighter regulation may adversely affect market freedom and initiative. As cautioned by Samuelson:

“The best policy is actually the middle way: not too much freedom for market forces, and definitely not too little freedom.” [Samuelson ibid]

There are two concerns with regards to market freedom. The first is that freedom may produce inventions and experiments that, as mentioned earlier, produce new finance mechanisms which may not enhance welfare. For example, during the past few decades:

“A brilliantly inventive generation that has harnessed computing power and financial theory to transform the world of finance. Trillion-dollar global markets have sprung up on the back of techniques. Much good has come of that — and not only fat bonuses on Wall Street and in the City. The most valuable result of the new finance is that more people and businesses have gained access to credit on better terms ... But this summer (2007) has shown how far invention has raced ahead of intervention. Vital parts of the new finance take place in lightly supervised markets, as far from the glare of regulators as its practitioners can profitably get. That should be no surprise: regulation imposes costs, restricts innovation and slows people down. Yet, with devastating speed, the crisis spread back into the heart of the most regulated parts of the financial system, the interbank markets and the market.” [The Economist 2007: 3]

Second, the past has memory. In the USA, monetary policy has been on the loose side for more than a decade, ‘pumping’ up assets of various sorts especially those in the housing market, while a ‘free’ financial market with less regulated lenders has lead the system towards the Credit Crisis. But how did the ‘pumping’ take place and what is the limit to market freedom? The issue is complex. It relates to the ability of the Federal Reserve to enforce rules and to perceive consequences. It also relates to its independence (those who spend the money should not print it), and to the limits set for its interference with the market.

We may recall that banks have long been the most highly regulated and tightly supervised private institutions. But, in the past few decades, the business of banking has changed much faster than the nature of its supervision. A major change in the era of securitization is that banks have shifted from the storage business — storing reserve capital to cover potential default — towards the moving business—trading securities around the globe and even betting by including those required as reserve capital in case of default. In such active circumstances, potential default is difficult to foresee. As a result, while respecting market freedom, Central Banks face a difficult task to set a balance between its two interrelated basic jobs: the...
medium-term pursuit of macroeconomic stabilization that sets interest rates to keep inflation in check and the short-term pursuit to ensure that the banking system has the right amount of liquidity. In the latter case, central banks in their attempt to remedy a dearth of liquidity may have to interfere with the market and go beyond their operational mandate. The issue is whether to leave the resolution of crises entirely to the market or to let the Federal Reserve intervene to resolve the crisis, thus taking the risk of creating moral hazards. Greenspan a former Chairman and veteran of Fed management presented a conditional response:

“Our country has long since abandoned the notion that we should leave crises to be resolved solely by the market place ... The critical need ... is to formalize the procedures improvised in the case of Bear Streams. This should insure that in the future, government financial assistance to lending institutions does not impact the Federal Reserve’s balance-sheet and monetary policy.” [Paperback edition of Alan Greenspan, 2008, The Age of Turbulence (Also quoted in The Economist 2008: 68)]

Greenspan’s condition, placed partly to minimize moral hazard, is to call for a standby panel to judge whether an institution should be saved by the government/Fed by guaranteeing its debts. Although a worthy innovation, this will probably lead to political tactics without resolving the preventive challenge. Mr. Bernanke, the present Fed Chairman, used the first part of Greenspan’s advice but not the second part leaving the door open for a wide range of possibilities.

Stabilization policies that aim for providing necessary liquidity must deal with mortgages—being an integral part of the global spread of newfangled securities. In the past few years, mortgage houses have changed in structure and methodology, thanks to new technologies and securitization. The latter process lured the mortgage business towards fast profit by various means such as minimizing the cost of debt, accepting low loan-to-value ratio thus increasing losses in case of default, and buying/selling mortgages as securities in the global financial market, thus moving into an alien trade with increased uncertainty. This type of behavior, adopted by the mortgage industry during the past few decades, has lead to a different mortgage landscape. At the end of 2007, the mortgage landscape in the USA was as follows:

“A fifth of all mortgages are taken out by the shakiest borrowers. About half those loans are written by companies that are almost entirely unregulated. The mortgages, on average, are worth almost 95% of the underlying house. Half of them demand no documentation of the borrower’s income. The loans are then bundled and sliced into complicated debt instruments ... The risk of these is gauged by credit-rating agencies which are paid by the very firms that created the securities and which make a lot of money from advising on how to win the best ratings ... Many of these structured debt instruments are bought by banks in other countries using off-balance sheet entities for which they make little capital provision and about which banking supervisors know virtually nothing.” [The Economist Report 2007: 26]

The data presented above indicates a pattern that leads to serious crisis. It did not develop abruptly. It took time to develop and mature, and evidently it has been set against existing rules and regulations. The emerging landscape raises two interrelated question: how to get out of the crisis as soon as possible—short-term remedies, and how to prevent its future reoccurrence—longer-term preventive measures.

On Short-term Remedies
As mentioned earlier, the Feds and the government focused more on rescue or salvage operations and less on regulatory actions especially as the depth of the crisis became more apparent. Early on, Mervyn King, Governor of the Bank of England was reluctant to provide liquidity on the premise that it may generate moral hazard. But, when the going got tough,
Mr. King ignored his rule and injected $20 billion into the interbank market. He was further obliged, again, against his rule, and extended an emergency line of credit to Northern Rock, a large UK mortgage lender. However, this latter move generated unexpected consequences. It reduced credibility in Northern Rock and created

“Britain’s first bank run since the 1860s, and caused all manner of wild worries about the whole British banking system ... The government managed to stop depositors queuing to withdraw their savings only by guaranteeing all their money.”

[The Economist Report 2007, ibid: 7-8]

Evidently, it is hard to avoid moral hazard in the midst of managing a severe crisis. Central banks’ actions should be carefully measured and timed.

Meanwhile, in the US financial market, where the crises have been severe, mortgage lenders, even the largest are exposed and calling for rescue. Early this January (2008), the Bank of America announced that it will buy Countrywide Financial, a large mortgage house in the USA for $4.1 billion in stock — a discounted price. The rescue operation had a different consequence. As a result, the Bank of America became both the US largest consumer bank and one of the country’s biggest mortgage lenders—a monopolistic move in the midst of a severe financial crisis. More recently, and probably more seriously and unexpectedly on July 13th, 2008, the US Secretary of the Treasury unveiled an emergency plan to save Fannie Mae and Freddie Mac, two mortgage giants that owe or guarantee $5.2 trillion worth of mortgages, a move that indicates that no large enterprise is immune to collapsing in the present crisis. The move also indicates that there is a fundamental change in the business culture; profits were privatized while the risks were socialized. The case of Fannie and Freddie indicates a significant change in market and political ethics that may influence market behavior for years to come. It may illustrate the difficulty, if not the uselessness in the long run, as Adam Smith previously indicated, of chartering private companies to fulfill government tasks. This has been the case of Fannie and Freddie. The case requires elaboration.

Fannie Mae was created in 1938 and Freddie Mac in 1970 as Government Sponsored Enterprises (GSEs). Their aim was supporting the secondary mortgage market. They both succeeded, owning or guaranteeing almost half of all US mortgages. However, their success reflects a strong government support and a few privileges that allow them to maintain far less capital that includes some shady items as preference shares and tax assets, thus they have lower borrowing cost than competition. But the presence of privileges generated power and greed which was enhanced by the invention of the newfangled securities. The companies built an astounding lobbying enterprise and provided their top executives with millions in remuneration. These activities lead to the financial scandals of 2003-04, and consequently to a change in management. The blame in the scandals was placed on the change in business culture and not on the change in the assigned aim and the misuse of rules (cf. The Economist, July 19, 2008: 80). The market strategy of Freddie and Fannie was to buy mortgages from banks, thrifts and mortgage brokers, repackage them as newfangled securities, and sell them to investors around the world. Both companies ended up in serious mortgage debt that could have reached $5 trillion dollar in the absence of public rescue operations. This debt is almost equal to what the US government owes investors around the world. However, the proposal of the US Treasury and the Fed does not put forward a system for future regulation. The infusion of the Treasury and the Fed into Fannie and Freddie operations is a serious public commitment since as mentioned earlier, they own or guarantee half the country’s $12 trillion home mortgage debt. If the bailing supports private investors at the cost of taxpayers, then we
are dealing with evident ‘crony capitalism’: Investors reap the profit while taxpayers pick the risk.

The System at Work in the Global Era: Towards a Long-term Solution

How did the Western banking systems, including their central banks, reach such a messy situation with negative local and global consequences? Three factors seem to be behind the recurrence of financial crises with increasingly negative consequences. The first, as discussed earlier, is the pressure of the political system for short term solutions. For example, to fix the mess, political pressure was placed on Federal Reserve bank to “put money in the hands of households that would spend it in the near term” (Associated Press: 2008-01-17). Although this is an expensive short-term emergency remedy—costing the US Treasury between $50 to 120 billion, it ignores the basic issues responsible for the mess in the first place. Furthermore, the move encourages moral hazard, thus, increasing the probability of repeating the crisis. The second factor is the weakness of the present regulatory mechanism. There is a need for an International Financial Regulation Authority (IFRA), probably requiring an overhaul in the structure and reach of existing regulation, rather than the ‘tinkering’ suggested by the Economist Special Report (2007 ibid: 34). The third is to comprehend and anticipate the role of globalization in the processes of global finance and development. The remainder of this article, focuses on the last two factors, regulation and globalization—a longer term view.

On Regulation

What is required for the case of an International Financial Regulation Authority (IFRA) is to take off beyond the International Regulation (IR) recommended a decade ago by Eatwell and Taylor (2000). The suggested IFRA could build upon both the (IR) and the present Basel II accord. The latter is in the process of development by the Bank of International Settlements (BIS). In this framework, a revamped Basel II accord/IFRA should be designed to resolve basic systemic problems that became evident in the past few decades, and especially in the 2007 credit crisis. It is essential that a revamped Basel II/IFRA Accord becomes a global compulsory institution with a focus on systemic issues, thus meeting Greenspan’s condition of a standby panel to judge financial institutions’ activities with less political tactics, due to its being on a global level. Systemic financial issues, to be resolved by Basel II/IFRA, include balancing the cost and benefit of regulation — for example the regulation of all newfangled securities including those that are presently unregulated. Regulating these securities incurs cost—the cost of losing some of their income and social advantages. These costs are to be evaluated by Basel II/IFRA against the social benefit of reducing the depth and frequency of recurrent crises such as the 2007 credit crisis and its repercussions. Other systemic examples include the presence of a chain of skewed incentives—actions that may save the innocent but reward the foolish— that present vulnerability and loss of confidence in the overall financial system; balancing confidentiality with basic transparency as it is the case of Hedge Funds; among other issues included in the portfolio of Basel II (e.g., The BIS Financial Stability Forum on hedge fund, among others, in its website: www.bis.org).

As of September 7, 2008, the U.S. government announced control of Fannie Mae and Freddie Mac the quasi-public mortgage companies which own or guarantee almost half of the country’s $12 trillion in outstanding home mortgage debt. This could be the largest financial bailout in history. The two companies, publicly traded but also serving a government mission to support housing, were put in a conservatorship that allows their stock to keep trading but puts common shareholders last in any claims. Their top executives were ousted. Their future role, size and accountability are yet to be clarified. The case is viewed as ‘crony capitalism’ that allowed private investors to reap profit but left tax payers liable for the risk.
On Globalization and Finance

The role of globalization in financial development and regulation, and its impact on monetary policy has been detailed for the case of the United States in a recent book by Greenspan (2007), the former Fed Chief. There are some issues not included in the book that require elaboration. Following is a brief summary of Greenspan’s key issues followed by the additional issues. For Greenspan, the role of globalization in monetary policy is evident. During his long tenure at the Fed, globalization worked in his direction: It was credited for reducing inflation, thus permitted the Fed to provide enough liquidity for economic growth with low unemployment rates. Technically speaking, in that era, the Phillips curve was horizontally flat at low rates of inflation (around two percent) that were maintained at that level, regardless of fluctuations in unemployment rates, which were also low. This is a different pattern from the normal inverse relationship between the rate of change of money wage rates and unemployment rate. It is also different from Milton Freidman and Edmund Phelps longer-term vertical Phillips curve. The presence of a flat curve for long periods gave credit to the Fed’s policies, but at what price? Greenspan thought that globalization was on his side. I agree. It was on his side for two reasons, China’s exports, and the high savings of the non-western world. China’s huge exports at relatively low prices were essentially a gift to the Fed’s policies. With large and low priced imports, average prices were kept low in America. In such context, the role of globalization resembled an outsider fighting inflation on behalf of the home base. This process allowed the Fed to maintain low interest rates that in turn allowed high investment rates with less worry about inflation. But for more than a decade, these investments focused more on housing and other related assets. The result was increased demand for these assets with low concerns about ‘shaky’ borrowers, thus, allowing the credit crisis to develop and grow, almost unconstrained. The second reason is the presence of higher savings in Asia, and in the oil economies whose revenue from high oil prices exceeded their absorptive capacity. These external savings financed the US widening trade gap and government debt, and in the process increased liquidity in the financial sector. But the fundamental underlying weaknesses in the US economy were left blind. However, there is more to these global processes than weaknesses.

Global governance, finance and production systems have been changing in both pattern and power. The global production system is increasingly based on the disintegration of production and the integration of trade and finance with significant implications to global governance and development. It is a new era that requires major restructuring of political, economic and financial institutions (cf. Sirageldin 2007). Classification of economies as industrial versus non-industrial, or advanced versus backward is vanishing. It is replaced by a complex individual-collective system based on the use of force, internal or external. The reliance on external production that replaces its own, as was the case in Greenspan’s tenure, is more than a financial convenience. The process has been viewed as part of economic growth. It is not. In a disintegrated system, production processes and finance are allocated across the global market based on relative efficiency and returns. A return to old norms may not be possible. It is a return into a highly competitive disintegrated production system and new global financial and governance systems. It is not a return to the old pattern.

Finance, production, trade and governance are integral parts of the global system. The presence of global governance and global monetary institutions (like for example Basel II/IFRA) — with the needed changes and authority with respect to rules, regulations and

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9 The reader may notice that in the previous discussion we focused more on the monetary side of the economy. The following examines briefly the impact of the Credit Crisis on the production and employment side of the economy. For details, see Sirageldin (2007).
compliance monitoring — are a necessity to reduce financial breakdowns and economic upheavals and to establish a peaceful and humane global society, and guarantee its survival (Sirageldin 2007).
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