1. Timeline of crisis and introduction

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1.1 INTRODUCTION

The word ‘global’ appeared in the Australian financial press discussions of what was then described as the *international* financial crisis in 2008. The world has since come to accept the term ‘Global Financial Crisis’ (GFC). It is everybody’s knowledge that the GFC mutated during April 2007 and September 2008 to become the world’s most virulent banking/financial crisis to occur in 80 years. The GFC has ravaged the world’s economies, shaved world income by some US\$800 billion in 2008, slowed growth considerably in the three years since 2008, and hollowed out or killed some of the major financial players, not just in the USA and the UK, but also around the world. A lot has been written about this crisis. Do we need another book on this topic?

This book is a prognosis of the crisis as analysed by leading scholars and professionals in accounting, banking, economics, finance, law and regulation. This book also has a contribution by Ronald MacKinnon, a world-renowned scholar associated with the influential idea of financial suppression that led to financial liberalization and sequencing policy reforms in the 1980s across the developing countries. The book examines the subject from a broad perspective to encourage lessons to be learned from many dimensions and actions to be taken to avoid the excesses of the financial/banking markets during the past 15 years to 2009.

This book traces the origins of the crisis, examines the impacts on economies, and how so many titans of the financial world collapsed, while also identifying a number of lessons for re-governing/regulating the promised new world financial framework as being fashioned by the G20 nations, still hard at work at this task as this book goes to press. This book is the product of a carefully reviewed compilation of writings of contributors who presented their ideas and analyses at a public meeting in Sydney on 9 April 2010 before revising their contributions for the present volume. The aim of the book is thus to present a convincing in-depth understanding of

how the crisis originated in April 2007 in the USA – soon also in the UK – and thereafter spread to the rest of the world.

From about the year 1994, the UK and the US regulators had succumbed to powerful banking lobbies that were given credibility by the writings and speeches of prominent thinkers that fostered a false idea. This lobby helped to nurture hugely deregulated legal environments in the UK and USA, resulting in the greatest degree of financial-cum-banking deregulation in place by 2004. This idea was premised on a false notion that markets could correct themselves through self-regulation! With so much freedom, financial firms in those legal regimes made loans with little regard for credit-worthiness of borrowers in an environment of low interest rates hovering around 1 to 2 per cent per annum that deprived savers of incentives to save and importantly lowered investor vigilance on high-return investment products.

The UK's Gordon Brown espoused the same philosophy of what he called 'light-touch regulation'. His aim was to further foster and retain the recently-freed British pound as a world currency and to promote London as the world's greatest financial centre. Evidence available in 2010 suggests that the great titans of the world of finance controlling Wall Street and the City of London knew that debtors would default, after gouging unprecedented amounts of easy credits during 1994–2004, once interest rates went up, as they did in June 2004 to September 2006 with upward revisions by the US Federal Reserve. The credit splurge over 1994–2004 led to a huge liquidity build-up, fuelling bubbles in financial markets, accompanied by a bulge in mortgages that led to the sub-prime lending scandal in the USA.

Across the world, the financial sectors of several emerging new economies of the world had been deregulated by the 1990s on the urging of the World Bank and the IMF who advocated and carefully tutored the emerging economies to deregulate currency and capital controls. This global financial liberalization was justified by new ideas of the need for financial liberalization as espoused by academic thinkers (MacKinnon, Shaw, Fry) who were concerned about lack of capital for growth in emerging economies, so reforms brought about a high degree of deregulation of emerging economies. This helped knit the world's financial markets for currencies, bonds and shares of those emerging economies to those of New York and London. The world benefited from capital flows from developed nations, not from exchange rate reforms, which periodically worked to the detriment of smaller economies exposed to the vagaries of capital flows, be they from banks, portfolio investments, or as foreign direct investments.

The contagion from the crisis spread more to those economies which had (i) a high degree of financial deregulation and (ii) economic relationships with the West. The result was that the crisis spread rapidly to some

60 economies with those characteristics when the world markets for borrowing collapsed in September 2008. This pre-existing condition in emerging economies helped to spread the crisis from just a few developed economies to the rest of the world from September 2008 onward. For example, China, with 62 per cent of her trade going to USA/Mexico, while also holding huge amounts of US-dollar-based securities for servicing her world trade, felt the crisis impact. Unlike the democracies of the world, the freedom to make policy changes without any public discussion helped the leaders of China to pump the world's largest amount of stimulus package to regain and recover the growth path. Not so elsewhere, where consensus-building for resource mobilization took more time.

1.2 WHY DID THIS CRISIS OCCUR?

Why did this crisis happen? How did it spread to the rest of the world? What were the impacts and costs of the crisis? What were the failings of regulations and governance? Are there lessons to be learned from the crisis? These are the questions that the contributors to this book address in the 13 ensuing chapters. Before providing a summary of the contributions of the book, the reader is referred to a catalogue of events on how the crisis started in April 2007 and then spread to the rest of the world (Figure 1.1).

The first outward sign of trouble in the financial sector began with the mortgage firms failing in the major economies, notably in the USA and the UK. As is seen from the timeline of events in Figure 1.1, the first victims were the investors in New Century Finance, a large mortgage firm that went bankrupt in April 2007, some months *after* interest rates started to increase because Ben Bernanke of the US Federal Reserve Bank upped cash rates to cool the then high-growth US economy. The US economy had been growing due to the substantial credit splurge between 1994–2006 created by deregulation of bank-like firms, allowing them to merge freely and also to create more credit by taking mortgages off the accounting book through untested new linked-products with the false promise of high return in safe investment! When this weakness was noted by market participants, players withdrew their investments. Between April 2007 and July 2008 more financial firms, including those considered solid, started to go bust. Ordinary depositors lined up at banks to withdraw their savings across the world. It appeared then that the crisis came from sub-prime loans going bad: is this true?

With foreclosures of some 400 000 properties in the USA, mortgage repayments to the banks diminished substantially. Under the US property laws, borrowers just had to abandon the property with no legal obligation

Figure 1.1 Global financial crisis: major events on a timeline

to service the loan in what is termed no-recourse loans! Ginnie Mae and Fannie Mae were broke. The insurance titan AIG insured the risk of the mortgage-backed securities that the banks had been selling since 1994, the start of the property bubble, and that great name became another victim of the crisis. Merrill-Lynch went bust when stock and bond market prices tumbled as the interest rates increased: Bank of America bought Merrill for a pittance. Bank stock prices plunged to about 20 per cent of prices in 2006.

Herein lies the actual origin and the *real* reason why financial firms went bust in spectacular fashion. All kinds of lenders and the high street banks were unable to service the customers who had bought a special form of a derivative, a linked product, the so-called CDO (collateralized debt obligations insured by the likes of AIG), which are financial instruments described by Warren Buffet as the *financial weapons of mass destruction*.

These CDOs amounting to US\$12000 billion in 2006, that is 75 per cent of the real US economy, were sold to customers around the world by the Wall Street banks with offices in New York and London. These financial firms removed chunks of mortgages from their accounting books by selling them to investors expecting high returns as if these were safe investments. The rating agencies joined in to quality-rate these instruments as safe, with an A-rating! The result was an inside job of major banks reaping huge fees in such deals while ignoring the likely fallout when interest rates would go up. At the US Senate hearing in June 2010, Goldstein of Goldman Sachs admitted that his firm made money by selling bets on such an eventuality.

About 25 per cent of these CDOs were bought back by the banks at a discount of 25 to 45 per cent in 2006–07. A simple calculation will show that this amount of discount is a loss to the banks and must have depleted the wafer-thin regulatory equity capital of US banks many times over: regulations set it at 2.5 per cent of total assets as core capital. The CDO-led hollowing of finance firms is the *real* origin of the crisis. Information that was not in the public domain before the crisis, since this market was not a public market with routine disclosures, is now forthcoming in 2010. That reveals that the real reason for creating huge capital losses of major financial firms was the return of the CDOs to the issuers after the sub-prime failure.

It appears that the top end of Wall Street knew this could happen, but felt safe in the often-proven belief, by reference to history, that the governments would rescue the banks: the bigger the banks, the higher the likelihood of such rescue. Letting the big banks go bankrupt would lead to, for example, another world depression of the kind our forefathers experienced in 1929–33 when banks were allowed to fail and money was

made expensive at the time of the then financial crisis by the central banks not loosening credits.

As more and more financial firms failed across the world in the next 15 months from April 2007, the banks retreated to holding tightly on to their own cash, as well as the cash provided by central bank rescue packages, in order to preserve banking liquidity. Naturally the banks refused to lend to other banks, later also to normal non-bank firms, thus the essential *payment system* of modern economies collapsed. It is the latter action that actually led to signs of failure in the real sector: example, General Motors and Chrysler. That collective action by banks resulted in a worldwide blackout of cash in September 2008. Nobody could borrow any money! Normally about US\$400 to US\$800 billion could be raised easily at a time. This led to an ever greater number of financial firms (and later, real sector firms) going bankrupt from September 2008. What started as a regulatory-forgiveness-based financial crisis in developed nations metamorphosed into the Global Financial Crisis in that month.

1.3 ORGANIZATION AND CONTRIBUTIONS OF THE BOOK

To aid in the diagnosis of the crisis, the chapters of the book are grouped into four parts. The reader will find in Part I a discussion of the crisis as it unfolded and how the financial institutions responded as best as they could. Part II traces the impact on the economy. Given the serious impact on employment, we begin this part by discussing how unemployment increased around the world. The governance and regulatory framework are discussed in Part III. We focus on the failure of governance and the general lack of rules of prudence to govern financial activities, including excessive pay to top executives. In Part IV, the reader will find a set of lessons to be learned from the crisis.

1.3.1 Origin and Impact on Banking Finance

The chapters in Part I provide a clear description of how the GFC originated in two major economies, and then spread through to the rest of the world to some 60 nations. In Chapter 2 the reader is shown evidence that debunks the popular view that the origin of the crisis was sub-prime lending made worse by the sudden increases in interest rates in June 2004 onward. The contribution by Mohamed Ariff traces the origin of the crisis to the design of exotic derivatives traded in private markets, and sold to private parties across the world with promise of high returns at a time of

historically depressed interest rates worldwide. This chapter argues that the crisis happened because of massive deregulation of the financial sectors that permitted (i) financial firms to merge with savings banks, which made savings banks highly risky with high-risk products and (ii) banks to experiment with new financial products with unknown system-wide impact, while (iii) investor amnesia in search for high returns resulted in the failure of investors to discipline financial firms engaging in financial alchemy.

Investors were reeling with such low incomes from their investments in financial markets that they bought the bankers' promises of high and safe returns through *linked* banking products, which promised higher returns than those that are available on savings accounts. These linked banking products would not have existed in the form of private trades with no information, if, first, they were not ranked as safe by rating companies and second, regulators had not created light-touch, deregulated financial sectors in the UK and the USA. So, it is arguable that the failure to maintain significant key regulations such as Glass–Steagall Act provisions, failure to require sufficient reserves and failure to approve highly risky bets-based banking products being sold to customers are the very reasons for the emergence of the crisis.

The eminent scholar and thinker, Ronald MacKinnon adds his contribution to this debate by dubbing China as a new major immature creditor country still learning how to act responsibly to highlight how China's massive deposit of money in the US markets is partly to blame for the credit splurge. There is a continuing discussion around the world's capitals, except in Beijing, that the imbalances created by China's method of managing its currency and the world's demand for cheap manufactured goods are not sustainable. Serious thinkers such as Krugman, Stiglitz, Buffett, King and others have spoken loudly about the harm to the world economy if significant countries create huge imbalances such as is the case of trade surpluses in favour of a few countries seeking export-led growth.

Bill Evans, a leading practising economist in Australia's banking sector, revealed in his speech in Sydney, hard facts about how the crisis has increased the cost of intermediation for average Australian banks. He provided evidence presented at the public discussion on 9 April 2010 on how the structure of pricing for money in the banking sector has changed.* The cost of borrowing in terms of spread in buy–sell has gone up threefold for Australian banks to secure funds. Reports in late 2010 indicate that banks' return on equity for that year has fallen from 18 per cent to 15 per cent due to this and the banking spread has increased modestly after the crisis.

In Chapter 4 Kevin Davis suggests that the post-crisis regulatory target will be to increase the requirements for capital adequacy of all

deposit-taking institutions, a reality now with CAMEL III announced in August 2010. The big banks will have to have another class of bank capital providers who will be called upon to supply more capital when a bank is in need of liquidity, an idea under active consultation within the G20 nations. Believe it or not: for now, governments have avowed that they will not rescue insolvent banks in future crises. The Bank for International Settlement has come up with voluntary regulatory changes to be slowly eased in from 2013 to 2019 to achieve these ideals being discussed as the book goes to print.

1.3.2 Economic and Cost Impacts of the Crisis

Almost three years after the crisis, a key economic damage has been noted as the inability of major economies to create jobs for the average workers. The issue here is the impact of the crisis on employment. In a joint chapter with Melisa Bond, Noel Gaston provides a substantial discussion on the winners and losers of labour participation. While the crisis had made things worse for some countries such as the USA, some others with resources have spent money – the so-called stimulus spending – to reverse the impact on employment. Australia's new labor government had a huge pot of money as budget surplus in 2007 left by the outgoing coalition government. This money came in handy to spend as a huge stimulus to regain employment. The incoming labor treasurer took credit as a great economic magician creating some 600 000 jobs on the back of the resources-boom-led demand for Australia's resources by spending the large stimulus. China spent the world's largest amount of stimulus money to regain growth and employment. We think that the ability of firms to create jobs will remain a major economic issue of the next decade long after the crisis has abated, given the unbalanced growth strategy of some major countries.

Tony Makin makes an analysis of the fiscal impacts of the crisis on how governments respond in handling the budget issues. His insightful comments, supported by sound theories and observations, predict the dilemma faced by policy-makers to address recovery. While prudent policy dictates that the long-run welfare is assured by restraining expenditure, the short-run objective of politicians used to short-term election objectives is to stimulate economic activities first to regain employment and second to reduce welfare expenditures if more people become unemployed from budget trimming. This piece is a significant contribution to the debate on policy correctness and policy rightness.

The cost to all economic agents has been substantial in this crisis and this needs to be documented. Ahmed Khalid's chapter is an excellent dialogue

on this issue. While the aggregate impacts on the GDP of countries are easy to illustrate, it is difficult to examine costs at other levels of the economy. He documents such issues as decline in net repatriation of residents of countries with foreign workers. The impact on trade, on emerging economies, the costs of stimulus packages and the costs of rescue packages are important cost items on which this chapter provides facts to the reader.

1.3.3 Governance and Regulation

In a broad sense, the GFC can be characterized as a massive failure of governance of financial firms in major economies. John Farrar identifies key issues of the GFC as regulatory failures. He discusses the relevance of corporate governance, particularly the governance of financial institutions. He focuses on key government failures and then discusses the redefinition of the regulated state and how efforts in those directions can improve the governance of financial institutions.

Capital market reform is on top of the agenda of IOSCO. Jane Diplock provides some significant insights into the new regulatory processes that are needed to avoid a future repeat of crises. Her argument is that modern finance corporations are interlinked just as animal species are interrelated in a natural environment. The consequence of what the financial market players do by way of innovations and business actions may have significantly different effects on an economy from the impact on, say, the banking sector. The increased interrelationship of the economy on financial actions is little understood, and so there is a need for new thinking on how to bring in that knowledge of the system-wide impact of one actor on the whole financial sector and the economy. IOSCO has tasked itself to look at this aspect to ensure financial stability, which is studied from a broader perspective than from the narrow perspective of a single sector such as is the case when a regulatory body, for example, a prudential regulator, examines regulations on what is good for banking and its customers, ignoring the system-wide impacts.

The contribution of another senior regulator, Wayne Byrnes of the Australian Prudential Regulation Authority (APRA) is on the subject of how each country balances its own interests against those of international interests. It is a lesson on policy objective-setting as well as the thorny road to ensure international consensus on what is good for the world as a whole in financial regulations. The message that comes from these three contributors is that governance is an important issue, and that one needs to have a holistic aim of what regulations the overall economy needs while not forgetting the private interest of nations that is in conflict with regulations that will be good for the world.

1.3.4 Lessons Learned?

The last three contributions of mostly practising economists are on the subject of lessons to be learned from this opening crisis of the twenty-first century. One key governance issue is executive compensation as in financial and real sector firms, which have been excessively high, often irrespective of performance. Allan Fels brings his in-depth knowledge of this topic to the readers. He examines the steps, sometimes hesitant ones, taken by governments to control this behaviour. The progress being made on this front is addressed by him.

Jeffrey Carmichael discusses the major lessons learned for regulatory reforms from this crisis. He is ably qualified as a noted academic, senior regulator and now CEO of an investment firm to draw key lessons from this crisis. At a narrower level, the inadequacy of international institutions to perform their required tasks is highlighted by Ross Buckley. He takes on a radical idea of closing down international institutions that are failing to deliver outcomes enshrined in their constitutions. According to him, the IMF should be closed down.

In a joint chapter on how the rules of accounting have been changing with pressure groups demanding certain directions, Graham Dean and Frank Clarke provide a critical exposé of what has gone wrong on this regulation-setting front. This chapter provides insights on how regulatory capture can also occur in professions, in this case accounting-rule-setting professions. Wrong-footed standards are often the result of special interests pushing for specific standards, which has serious detrimental long-run consequences.

1.4 COMMENT

The ideas expressed in this book are from careful observations of what has transpired during the period April 2007 to April 2010. Many more discussions on how to reform – a better word is refine or re-govern – the rules of actions for the financial sectors of the world are still ongoing, and are unfinished business at the time this book goes to print. What emerges as a clear fact is that the GFC happened because US- and UK-based lobbies persuaded governments to allow financial institutions to have a much freer hand in their business activities based on the fallacy that self-regulation would suffice, so existing safety-first regulations were taken off. Second, new untested ideas hoisted on to the financial sectors could have unintended effects if the system-wide impact is not taken into account. If the public are enticed to place bank deposits with a bet on something else

(linked products) – and the prudential regulators do not see this as wrong-footed – as the only way to obtain decent returns on life savings, then this would, and actually did, have a disastrous impact on the system when the bets came off from April 2007!

As Jane Diplock, an internationally-savvy regulator, has persuasively argued, the system-wide impact of how the financial market players' actions in a self-regulated environment affect the world economies in a *symbiotic* manner was still little understood in the 1990s as much as in 2010. A challenge to the G20 nations is to come up with what is good for the world, not just for some countries. This must be similar in spirit to how the Bretton Woods agreement was fashioned in 1946 with the aim to build a better world. Of course, after 30 years of excellent progress, the Bretton Woods institutions have become mammoths unable to achieve what they set out to do because of regulatory capture. The G20 nations and the advisors to that body have to set aside narrow interests of some countries and work for a better financial world than what we have come to witness since the breakdown of the Bretton Woods in August 1973.

While the old adage that regulators know how to fight the previous fire may be true, it would be wise to move regulations forward to fashion rules that at least prevent similar aspects of the current crisis from reoccurring. The world is awaiting the completion of the work-in-progress on this front from the lessons learned.

NOTE

- * Note from editors: The paper presented by Bill Evans is not included in this book. This is entirely due to the decision of the editors not to await for Bill to come back from his involvement in another project, which got in the way of timely submission of his contribution to this book. However, his comment, summarised briefly here, is valid, and policy changes are taking place in Australia in line with the hard facts as pointed out by him on how the GFC affected the industry.