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Commentary

BUFFIN PARTNERS INC. ECONOMIC INVESTMENT AND ACTUARIAL RESEARCH

The Global Financial Crisis

The Bank for International Settlements (BIS), a Basel, Switzerland-based international organization that fosters cooperation between central banks and other agencies in pursuit of monetary and financial stability, has recently published a 216-page report that contains valuable insights into the global financial crisis. The BIS report explains how the crisis has produced many challenges for policymakers, especially in industrial countries. In setting policies, a long-term perspective is necessary while at the same time managing a fragile and uneven economic recovery. Some measures have delayed the needed adjustments in the real economy and financial sector, where the reduction of leverage and strengthening of balance sheets are in progress. The combination of vulnerabilities in the financial system and the effects of policy implementation involve risks that could endanger reform efforts.

Macroeconomic support is beneficial, but the limits to fiscal stimulus have been reached in a number of countries. Immediate fiscal consolidation is being evaluated or implemented in some industrial countries. Such policies are accompanied by structural reforms to facilitate growth and ensure long-term fiscal sustainability. In monetary policy, despite the fragility of the macro economy and low core inflation in the major advanced economies, keeping interest rates near zero for too long, with abundant liquidity, creates distortions and risks for financial and monetary stability.

Reforms should produce more effective regulatory and supervisory policies as part of an integrated policy framework. A new global framework for financial stability will bring together contributions from regulatory, supervisory and macroeconomic policies. Supported by strong governance arrangements and international cooperation, this framework will promote the goals of financial and macroeconomic stability. Banks have increased their capital buffers, and profits have been boosted by a number of temporary factors. But banks still remain vulnerable to further loan losses. Although banks in the crisis countries have made some progress in repairing their balance sheets, this process is not yet complete. Central banks reduced policy rates during the crisis in order to stabilize the financial system and the real economy. Those essential cuts, reinforced by policy measures to address financial market malfunctioning, helped to forestall an economic meltdown. However, there are limits to how long monetary policy can remain expansionary. The financial stability risks that arise from a prolonged period of extremely low rates need to be carefully considered. An extended period of such low rates will encourage borrowers to shorten the duration of their debts, facilitate the increased leverage of risky positions, and delay necessary balance sheet adjustments. While policymakers can address such risks in various ways, it may be necessary to tighten monetary policy sooner than macroeconomic prospects alone might suggest.

Emerging market economies (EMEs) are recovering strongly and inflation pressures there are rising; some emerging market economies are in danger of overheating. Given low policy rates in the major financial centers, many EMEs are concerned that their stronger growth prospects could attract destabilizing capital inflows, leading to currency appreciation. Some continue to keep policy rates low and resist exchange rate appreciation by conducting large-scale intervention in foreign exchange markets. Such policies tend to be associated with a sizeable expansion in bank balance sheets, rapid credit growth and asset price increases. To promote more balanced domestic and global growth, some EMEs could rely more on exchange rate flexibility and on monetary policy tightening. In addition, prudential tools have an important role to play in enhancing the resilience of the financial system to domestic and external financial shocks.

GDP growth in most advanced economies is still well below pre-crisis levels. The rapid increase of government debt is raising questions about the sustainability of public finances. Current budget deficits, partly cyclical but also affected by policy responses to the crisis, are large in relation to GDP. High levels of public debt may lower long-term economic growth and ultimately endanger monetary stability. Tackling the long-term fiscal imbalances requires structural reforms aimed at boosting the growth of potential output and containing future increases in expenditures. Such measures may have adverse effects on output growth in the short term. Fiscal consolidation, cutting deficits over a number of years, is expected to result in low and stable long-term interest rates, a less fragile financial system, and better prospects for long-term growth.

The crisis revealed that some business models of financial firms were seriously flawed. Financial firms earned comparatively low returns on assets, but used high leverage to meet targets for returns on equity, while taking advantage of available low-cost short-term funding. This strategy made their profits more volatile, especially during periods of market stress. Since the crisis, evaluations of financial firms have become more discriminating, recognizing those with more prudent and resilient models. The priority of policymakers now is to incorporate stronger standards in the regulatory framework. Higher-quality capital, lower leverage and more stable funding will improve the sector's future resilience.

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