SEVEN LESSONS OF THE GLOBAL FINANCIAL CRISIS (#1)

(sumber: https://www.rti.co.id)

Lesson Number One: Financial crises do occur frequently

Financial crises tend to occur frequently - Barro Ursua have identified 148 crises since 1870 in which a country experienced a cumulative decline in GDP of at least 10%. Reinhart and Rogoff also identified 104 banking crises across the world since World War II. What is the explanation for such frequent occurance of financial crises?

> *“People do not learn from past mistakes, e.g. in September 1998 the collapse of the LTCM led ti calls for revamping the financial system, but within one year all the momentum was lost because the markets had returned to normal and it was "business as usual"; or people learn the wrong lessons and therefore apply the wrong medication. While no two financial crises are exactly the same, the basic underlying causes are usually rather similar: human greed leading to excessive risk taking that pushes up asset prices, made possible by excessive leverage that subsequently collapsed.”*

Lesson Number Two: The bigger the mistake the heavier the punishment

Usually markets are very good in punishing mistakes. The bigger the mistake, the heavier the punishment is. Asian economies made some mistakes in the 1990s, and they were punished heavily in the Asian Financial Crisis. However, this latest round of financial crisis differs from past crises after World War II in that it happens in the very core of the global financial system. As the scale and severity of the mistakes are unprecedented, the crisis has led to an even more devastating punishment.

Lesson Number Three: Financial innovation has not led to greater financial stability

Surprisingly, financial innovation or financial engineering in the last twenty years has not led to greater financial stability. Rather it has become a source of financial instability. This is in stark contrast with other forms of engineering innovations that we know of. Clearly lending to sub-prime borrowers, who cannot afford to pay back the money unless property prices keep on rising, was a breakdown of basic risk management principles. However, through securitisation and clever financial engineering, it was possible to package and distribute securitised sub-prime mortgages or other low-quality loans into top-grade investment instruments, using what we now know to be flawed assumptions and modelling.

At the same time, the creation of very complex financial derivatives such as CDS and CDO/CDO Squared enabled firms, financial and non-financial, to take excessive risks without adequate support of capital, as high leverage was embedded in these instruments that could easily be hidden as off balance sheet items.

As these complex financial derivatives were traded over-the-counter, there was almost total opaqueness in the size, volume and concentration of the derivative markets, If the senior management of many financial institutions did not fully understand the true leverage and risks embedded in these complex and opaque financial derivatives, it was not surprising that regulators had a hard time in coming to grips with these instruments and the risks they would pose to the financial system.

Lesson Number Four: The growth of shadow banking system contributing to financial instability

In the US, the development of a shadow banking system, in which money market funds played a major role, was another factor contributing to the severity of the latest crisis.The money market funds, which were subject to much lighter regulation, reached a mammoth size of US$3 trillion in 2007, roughly half the size of the total bank deposits in the US. Following the collapse of Lehman and two major money market funds, there was a run on this shadow banking system, resulting in a huge liquidity squeeze on the rest of the financial system. This would have caused a collapse of the entire system if not for the US Government's rescue. While there is now strong international determination to improve the safety and robustness of the banking system, mainly through the strengthening of capital and liquidity requirements, one must not lose sight of the risk of pushing even more financial intermediation activities to the unregulated sector of the financial system, resulting in further undesirable "regulatory arbitrage".

Lesson Number Five: Breakdown of self regulation/correction of financial markets

Given the many traumatic events that happened in the last two years, it is now widely recognised that self-regulation or self-correction of financial markets was not enough to prevent excesses and malpractices in the system. Many supporters of market-based "gatekeepers", such as internal and external auditors, rating agencies and analysts, in warning against deficiencies and problems, let alone preventing them from happening. Going forward, tighter regulation of the financial system and its participants is therefore needed.

Lesson Number Six: Quality of regulators is as important as regulatory structure

Given that global financial crisis has hit so many developed economies with different regulatory structures, such as the centralised mega regulator model in the UK or the decentralised model in the US, it adds credence to the argument that no single regulatory structure is inherently superior to other structures and sufficient to prevent systemic crises from happening. There is no doubt that each economy must learn from this crisis and do whatever necessary in closing the gaps in their regulatory structure that have been identified. However, no matter what structure one would go for, it is equally, if not more, important for the regulatory agencies to have the right people with the necessary professional expertise and weaponry to do the job.

SEVEN LESSONS OF THE GLOBAL FINANCIAL CRISIS (#2)

Lesson Number Seven: Financial stability work must not be allowed to fall between cracks.While there is general agreement that financial crises can have serious disruption to economic growth and employment, there is yet no consensus on whether and how central banks should take into account financial stability or asset prices in determining monetary policy. The latest crisis demonstrates clearly that consumer price stability can exist even when significant financial imbalances are building up. Trends in globalisation in the last 20-30 years - such as the entry of China, India, Eastern Europe into the global market economy which doubled the world's labour supply - have allowed central banks to maintain lower consumer price inflation that it would have been possible when domestic factors alone were in play.