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Global Financial Contagion: Building a Resilient World Economy after the Subprime Crisis, by Shalendra D. Sharma (Cambridge University Press), 2014, US$ 36.99

Six years after the great financial crash shook the world in 2008 its after-effects continue to be felt as the global economy struggles to regain its lost momentum. The depth and impact of the great crash was unlike anything the world had seen since the Great Depression, and it is therefore not surprising that scholars continue to debate the reasons that led to the crisis, and the way out of it.

The profound impact of the crisis has led several scholars to grapple with its causes and to identify remedies that will prevent a repeat of such an event. In his recent book, *Global Financial Contagion: Building a Resilient Economy after the Subprime Crisis*, Shalendra D. Sharma, a professor in the Department of Politics at the University of San Francisco, provides a lucid summary of the origins of the crisis, its aftermath and the way forward. The author examines the evidence presented by a broad cross-section of economists on the economic crisis and sheds light on the economics and political roots of many of the economic problems. He expresses his ideas and views in ten well-organized and well-linked chapters. In these chapters he examines in detail how the economies – Eurozone, Russia, China, India, East Asia and the Middle East – have been impacted, what their responses were and what will be G20's role in this direction.

The origins of the crisis and the US response

Sharma points out that the three decade long period of great moderation in the US led to complacencies and lax policies which fuelled the financial crisis. The deregulation of financial markets accompanied by easy monetary policy led to excessive risk-taking by financial

institutions. The benign macroeconomic environment led to hubris among policymakers who turned a blind eye to the growing risks.

According to macroeconomist John Taylor, interest rates were held far too low for far too long, fuelling asset bubbles, particularly in the housing industry.

As Altunbas (2010) of BIS has shown using quarterly balance sheet data of banks in the US and EU, a loose monetary policy can affect risk-taking in at least two ways: (i) through their impact on valuations, incomes and cash flows which in turn can modify how banks measure risk and (ii) through a more intensive search for a yield process, especially when nominal return targets are in place. These two ways may be amplified if agents perceive that monetary policy will be relaxed in the case of decreasing asset prices in a financial downturn (the so-called insurance effect) causing a classic 'moral hazard problem'.

The problem of moral hazard was aggravated because of the bailouts during the loans and savings crisis of the 1980s and the subsequent bailout of Long Term Capital Management, orchestrated by the Federal Reserve of New York a decade ago. These bailouts set the wrong precedent, creating a belief that the Fed would 'send in the cavalry' to rescue the financial sector whenever financial institutions faced a liquidity squeeze. 'The unqualified optimism or the "irrational exuberance" that such a promiscuous culture spawned took the underestimation of both risk and risk taking to new heights by inducing banks, non-bank financial institutions, and institutional and individual investors to increase their leverage and take increasingly aggressive (and risky) gambles,' writes Sharma.

As if these trends were not egregious enough, regulators went a step further and repealed the Glass-Steagall Act of 1933 which had maintained clear walls between the transparent and regulated world of commercial banking and the less regulated world of investment banking, and which had been a bedrock of financial stability since the Great Depression. Under the old regime, commercial banks, investment banks and insurance companies had divergent interests and their lobbying efforts tended to offset each other. But its repeal led to the creation of huge financial behemoths with convergent interests, giving the financial industry disproportionate clout in shaping the country's political and economic agenda, the author argues.

There were several political roots of the economic crisis. The growing clout of the financial industry and the consequent policy environment of light-touch regulation was one cause of excessive risk taking. The other problem arose from the political agenda of inclusiveness in home-ownership. There was a great deal of bi-partisan support in the US for the excluded to own homes, leading to relaxation in under-writing standards of mortgages, creating the initial conditions for a perfect storm in the housing market. The growth of the securitization industry and its increasing opacity meant that there was no way to price risks accurately.

It was ultimately these structural problems, including the lack of transparency, that led to the banking panic. As Gary Gorton argued in a 2007 research paper, it was not the case that all bank assets became toxic all of a sudden but the bursting of the housing bubble which was evident in rising foreclosures and the illiquidity in the corporate repo-market (which was at the heart of the links between the traditional and parallel banking systems) which led to a crisis of confidence. The fact that it was impossible to identify the precise location or magnitude of the risk and hence to price it, especially for the CDO and CDO-squared's made all securitized transactions look toxic to investors causing a hurried exit from the repo market, accompanied by distress sales. The panic also led to a multiplier effect on the fall in home prices as mortgage-sellers discovered that there were few takers at the going prices as the reality of the credit excesses of the past sunk in.

There were profound political changes underlying the economic transformation in the US. The author documents the rising campaign contributions of the financial industry in the years leading up to the crisis and argues that the nexus between financial and political elites made such excessive financialization and deregulation possible, which might have aided growth in the short term but ended up creating the crisis. The other consequence of such an arrangement was a neglect of the anxieties of the lower and middle classes, who were increasingly feeling left out in the new economy. A palliative came in the form of

easy credit which worked in the short-run but ended up creating long-term problems. Sharma also cites Prasad and Rajan to buttress his case. According to Prasad (2012), the US has long promoted consumption-driven growth as an alternative to a welfare state. Hence, easy credit has served as an alternative to the country's poorly developed social welfare system. Rajan (2010) has argued that the political response to growing inequality in the US was in the form of easy credit, which provided the immediate gratification of greater consumption and jobs while postponing paying the inevitable bill to the future.

Sharma argues that the US response to the crisis was unimaginative, and the bailout packages of the Bush and Obama administrations were built on a false 'Keynesian' hope that state backed stimulus packages could lift the economy. The author is also critical of the Obama administration's efforts to correct historical inequalities by spending on education and universal healthcare though he does not outline what the alternative could be. Sharma writes that spending by the US treasury has failed to boost the economy to a sustained growth path. While it could be true that some of the spending has been wasteful, the author fails to examine the counter-factual: what the state of the US economy would have been in the absence of the stimulus packages.

The contagion effect

The rapid pace of globalization of the financial and real economy over the past few decades led to a contagion effect across continents, writes the author. Europe's economy was most vulnerable because of its deep linkages with the US, similar financial and real estate problems as the US and also because of the high levels of sovereign debt in peripheral European economies such as Greece and Portugal. As credit markets froze following the great cash, the vulnerabilities of the peripheral economies and the contradictions within the European Union came to the fore. Despite adopting similar stimulus packages as in the US, it has been even more difficult for Europe to stabilize its economy.

The monetary compact of the European Union (EU) without a similar fiscal compact has proved to be its weak spot. The difficulties of

coordination among economies that are recovering at different speeds within the union has only exacerbated risks and raised costs of funding for sovereigns with weak balance sheets. The author is of view that the chances of a breakup still remain and the future of the EU does not appear bright without deeper fiscal integration.

The author suggests ‘Although confidence has improved (that is, risk aversion has been tempered) since the ECB (European Central Bank) offered to buy the bonds of struggling economies, namely Spain and Italy, the bloc must continue to improve investor confidence by aggressively pursuing and building on the gains of the past three years.’

The financial crisis not only impacted Europe but also left a deep scar on the rest of the world. Although the origins of the Great Recession and its rapid transmission lay in the financial sector, world trade was not immune for very long, writes Sharma. Emerging economies experienced twin shocks --- first, a sudden stop of capital inflows driven by global deleveraging (and the resultant unwinding of positions), and second, a collapse in export demand. Countries with poor or limited global financial linkages were mainly impacted through the trade channel, whereas countries with deeper financial linkages were impacted via the financial channel. The ones most adversely impacted were economies with high current account deficits, high levels of indebtedness, low foreign exchange reserves and imprudent credit growth. Most developing economies were negatively impacted because of large-scale drops in commodity prices, deterioration in their terms of trade and the tightening of global credit.

Sharma highlights two key factors behind the sharp contraction in global trade. The first is expanding vertical specialization, where countries specialize in a particular stage of a good’s manufacture or assembly, causing increased dependency on global supply chains. The rationale is that intermediate goods typically cross borders several times before being assembled into a final product, and any disruption of product inputs negatively impacts all, especially countries ‘downstream’ or at the later phases of production as they have the higher imported content

in their exports. Second, since international trade requires various types of financing, the extremely tight credit conditions and the resultant shortage of liquidity (especially US dollars), coupled with rising cost of trade finance, contributed to a sharp fall in economic activity.

The global response and its limitations

The author argues that the global crisis has created a crisis of confidence in the market-driven economy and led the world to seek alternatives that can yield greater stability: 'In the aftermath of the crisis, the view that markets are inherently volatile, unpredictable, and prone to booms and busts, and thus require the guiding hand of a benevolent state to repair wrecked economies and protect average citizens from the corrosive impact of crises and crashes, they had no role in creating, seems to be again ascendant.'

The author also hypothesizes that this shift towards activist states that make important interventions in the economy may reflect 'only a fleeting and ephemeral pendulum swing' rather than a paradigm shift. He is doubtful that an activist Keynesian state can be the solution to today's problems. The solution, in his view, lies in the design of improved political institutions that can allow market economies to function efficiently, while tempering the excesses that markets and self-interested behaviour can sometimes lead to. In order to more effectively balance regulation and risk, the author suggests generating a creative synergy of markets and government, or what the 'varieties of capitalism' school has described as 'institutional complementarities'.

The importance of credible and effective institutions at a global level is as much as it is at the domestic level *albeit* it is much more difficult to put in place such institutions or even a credible framework at the global level. Like previous episodes, this crisis has also led to calls for a new international financial architecture that is resilient to financial shocks and is more equitable and sustainable. But the author is not very hopeful about progress on this front, nor does he see a decisive agenda for change backed by key economies.

The author quotes economic historian Charles Kindleberger to drive home his point that the absence of a powerful hegemony in today's world has led to a state of flux, with little progress towards rebuilding the global financial architecture and putting the global growth engine back on track.

'The conspicuous absence today of a global leader is again making the painstaking work of stabilising the international order exceedingly difficult,' writes Sharma. However, in the absence of a hegemony or concert of powers, a multilateral body such as the G20 can be expected to find a way out of the global mess but the author is not very optimistic about the grouping. He argues that after an initial phase of decisiveness and joint action in the immediate aftermath of the crisis, the cohesiveness within the group has disappeared and it is unable to make headway in addressing core issues of global imbalances.

Sharma also points out that the initial response to the crisis in the form of a coordinated global stimulus by major economies was a panic reaction driven more by self interest than anything else. As the economic recovery began proceeding at different speeds in different major economies, fissures surfaced within the G20. The widening distance between national and global interests meant that coordination became increasingly difficult. This was particularly so in relation to monetary policy. While the US tried to isolate China within the forum for failing to rebalance its economy and recalibrate its currency, Washington's own pursuit of self-interest by driving an expansionary monetary policy which endangered the fragile recoveries of emerging markets, was called into question.

Even in areas where the G20 agreed such as on the new Basel norms, implementation was delayed. The G20 has very little to show in terms of actual outcomes after that initial spark of bonhomie in the immediate aftermath of the crisis, contends Sharma. However, it is rightly pointed out that the institutional weakness of the G20 has prevented it from playing a truly decisive role in reshaping the world economy. The G20 lacks a formal adjudicating and enforcement system. It even

lacks a formal voting system so it is not possible to ascertain different members' views, and all agreements are those which are agreed upon by consensus. Its utility has diminished steadily since the crisis as argued by the author.

In *Global Financial Contagion*, Sharma may not be presenting a novel or original insight into the problems plaguing the global economy, but he manages to provide an accessible account of what went wrong in the run-up to the crisis and how efforts at global coordination have faltered since then. The book also exposes the problems with multilateral structures that are supposed to lead the way out of the current mess, and ends on quite a pessimistic note on the future of the global financial architecture and the global economy.

Devasmita Jena*

* The author is Research Officer, Department of Economic and Policy Research, Reserve Bank of India, Mumbai.