The Global Economic and Financial Crisis: Which Way Forward?

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1 Introduction

This chapter provides a review and commentary on the current financial and economic crisis. It considers important analytical and policy issues from a global and North–South perspective. The analytical issues include the reasons for the better than expected performance of the world economy following the early period of acute crisis, the role of global financial imbalances, and whether or not economic theory has been helpful in explaining the causes of the crisis. It is argued that close international cooperation and policy coordination are essential to continued recovery and improvement in the distribution of the fruits of growth. Cooperation and financial regulation are particularly necessary in order to prevent international contagion and cascading sovereign debt defaults.

It is generally accepted that the acute phase of the current global financial and economic crisis began in September 2008, with the demise of Lehman Brothers – a leading US investment bank. Eighteen months later, and in the context of the continuing global economic and financial crisis, the following issues require careful analysis:

- Why the world economy has performed so much better than most analysts had expected at the beginning of the crisis.
- Which economic theories, if any, have been helpful in explaining the course of the crisis to date.
- To what extent, if any, were regulatory deficits in the field of finance and global financial imbalances responsible for the crisis?
- How should the world’s financial system be organised so as to secure maximum sustainable and equitable growth for the real world economy?
The question of government debt and of the danger of inflation. Other salient policy issues that have come to the fore, including that of the drawing down of sovereign debt.

While the economic significance of the above issues is self-evident, not all can be treated satisfactorily in a single paper, hence only a relatively few issues will be examined in detail.

2 Economic and financial crisis and the global economy

It is generally agreed that difficulties associated with the housing segment of the US property market were the immediate cause of the crisis (see, for example, International Monetary Fund (IMF), 2008a). Complex financial instruments that incorporated subprime house mortgages lost their value as the housing bubble burst following ten years of continuous price rises based on expectations of a continuation of such increases. This housing bubble occurred despite the fact that during the previous two decades the supply of housing had increased appreciably (Solow, 2009). In brief, house prices had risen because interest rates were low and credit was easily available, and prices were expected to continue to increase, much as in the case of the classic tulip mania and bubble in the early seventeenth century when, at its peak, the price of a tulip bulb in Holland was equivalent to that of a three-storey townhouse.

Housing bubbles have occurred many times before in American economic history without leading to an acute economic and financial crisis, let alone in the rest of the world. This episode was different in that it was accompanied by a bubble in US share and other asset prices. Moreover, the bursting of the US housing bubble led to a fall in share prices not only in the US but also around the world. This was due to the much closer integration of world stock markets resulting from the financial globalisation that had occurred in the previous two decades. It is interesting to note that bank losses due to the failure in the subprime mortgage market are estimated to have been around US$250 billion. The consequent financial crisis led to a sharp fall in aggregate world stock market capitalisation of the order of US$26 trillion in one year – nearly one hundred times larger than the losses associated with sub-prime mortgages. Robert Solow (2009) notes that the combined result of the housing and the stock market shocks was a fall in US household wealth from US$64.4 trillion in mid-2007 (before the crisis) to US$51.5 trillion at the end of 2008. Thus US$13 trillion of household wealth has been lost.