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No respite, 5 years after Lehman

Five years after the Lehman Brothers collapse triggered the global financial crisis, there are still no effective financial regulations in developed countries, while the developing countries face big new challenges..

By Martin Khor

This week marks five-year anniversary of the collapse of Lehman Brothers that was the immediate trigger for the United States and global financial crisis.

Lehman was the tip of the iceberg. Below the surface were many contributory elements. They include financial deregulation, the conversion of finance from serving the real economy to a beast that thrived on speculation, creaming layers off the productive sectors and unsuspecting consumers through new manipulative instruments.

The US sub-prime housing mortgage crisis was the boil that burst---where massive loans were given to home-owners who could not pay, the loans were securitised and sold to unsuspecting investors, the derivatives magnified the proportions of the crisis, while the bankers made billions selling very risky "financial products" as very credit-worthy investments.

Many collapsed or collapsing banks in the US and Europe had to rescued in bailouts totalling trillions of dollars.

The crisis also exposed the deep deficiencies of the global financial system. Globalisation of finance meant a crisis in one part could be quickly transmitted to other parts of the system.

The deregulation of capital flows caused booms and busts in emerging economies that received inflows and then suffered sudden reversals. The lack of a stable system of currency rates results in big fluctuations.

The lack of an international arbitration system for resolving sovereign debt crises meant indebted countries could be mired in a debt-income death spiral for years.

Five years later, the lessons have not been learnt with respect to the US, according to Princeton University economist and former Federal Reserve vice-chairman Alan Blinder, in a Wall Street Journal article. The US Dodd-Frank Act of 2010 was a weak response to the crisis which, worse, is withering in the poor follow-up.

“Far from being tamed, the financial beast has gotten its mojo back and is winning. The people have forgotten and are losing,” concludes Blinder, giving four examples of how Dodd-Frank is not working.

First, on mortgages and securitisation, the rule that Wall Street firms that issue asset-backed securities retain at least 5% of the credit risk (and thus make them cautious on what they securitise) has definitional escape clauses that allow exemption for up to 95% of all mortgages.

Second, the attempt to rein in the deadly derivatives that was the source of reckless leverage that blew up in the crisis, has been woefully inadequate. Dodd-Frank calls for greater standardisation with safer and more transparent trading environment -- but the law exempts the vast majority of derivatives, and the implementation of this already weak law has run into resistance.

Third, although credit rating agencies were blamed for its role in the crisis by blessing financial junk with top ratings, the Congress has so far only asked for a study to reform the way the agencies work. The report has come out but is gathering dust.

Fourth is the attempt to ban banks from “proprietary trading”, i.e. gambling using their own funds. The so-called Volker rule has not been implemented since Dodd-Frank became law in July 2010 because of resistance from the banks and bureaucratic squabbles.

Blinder warns that the Doo-Frank Act is “taking on water fast” (meaning: the ship is sinking) and proposes that the new Federal Reserve chair must move bureaucratic mountains and fend off banking lobbyists, instead of sympathising with Wall Street.

But the tone of his article is pessimistic indeed. We can conclude we can’t expect effective changes in the US, where inadequate policy response and roll-back are caused by the strong banking lobby, the weak bureaucracy and an accommodative Congress and administration.

Five years after Lehman, if the situation is bad on the regulatory front, it has even worsened in two other areas.

One is in economic policy to counter the recessionary effects of the financial crisis. The Keynesian-type reflationary actions of major economies coordinated by the G20 (through its London summit of 2009) did not last long, as conservative forces hit back with austerity-centred fiscal policies that seem to rule today in Europe and the US.

The big economies resorted instead to a cheap-and-abundant credit strategy, the most important of which was the “quantitative easing” policy of the Fed in the US pumping US$85 billion a month into the banking system.

But critics point out that this is planting the seeds of a new crisis in both developed and developing countries.

A significant outcome was the renewed boom of speculative capital to emerging economies, thus continuing the boom-bust cycle.

This brings us to the worsening in the second area. Many developing countries, which had recovered fast from the 2008-10 crisis now face new potential crises.

Their economic growth rates are dropping, their currencies falling, capital flows are reversing, and prices and demand for commodities are weakening.

Meanwhile the required reforms in the global financial system are still lacking: there are yet no adequate measures to stabilise currency fluctuations, to curb cross-border speculative capital flows, to discipline credit agencies, to reform the system of reserve currency, to set up a sovereign debt resolution mechanism, to assist developing countries facing financial and trade shocks.

One bright spark is that developing countries are taking measures to help themselves. The Chiangmai Initiative in which Asian countries can avail themselves to funds to fight off speculative attacks and fill in gaps in a balance of payments crisis, has been joined with a similar type of arrangement with US$100 billion funding by the BRICS countries, announced at the sidelines of the St. Petersburg G20 summit. A BRICS development bank is also to follow.

It is at times of crisis or impending crisis that countries are spurred on to new initiatives to defend themselves. .

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