The financial crisis of 2008, the worst since the Great Depression, spread recession all over the world. The global economy suffered from disruptions in financial markets, the bursting of the housing bubble and rising unemployment. After the crisis, numerous commentators pointed to the house price bubble, Wall Street greed, and subprime mortgages as the key factors that triggered such a devastating crisis. Meanwhile, some critics blamed the shortcomings of existing economic models in failing to foresee the crisis. This book, Prevention and Crisis Management, however, looks at the 2008 crisis from a different angle. Rather than elaborating on the most visible factors such as the hyper-bubble in real estate and financial markets, the authors explore longer-term structural economic problems that facilitated the crisis. First of all, the authors point to policymakers' pursuit of short-term economic prosperity through excessive public spending, expansionary monetary policy and financial deregulation. Secondly, the authors explore how global imbalances indirectly encouraged the crisis.

Prevention and Crisis Management, is a compendium of papers presented at symposia held at Kyoto and Hitotsubashi University in 2009 and 2010 which were organized to analyze the 2008 crisis and discuss lessons for Asia. Comprising 13 essays written by experts from various fields including international economics and finance, the book is divided into three parts. The first section of the book explores the factors behind the crisis. The second section focuses on preventive measures for future crises, examining warning indicators, such as current account imbalances and external debt levels and how these correlated with the change in cumulative output during the crisis. The third section covers the role that global imbalances played in facilitating the process of speculation in the financial and housing markets.

Within the consideration of structural problems behind the financial crisis in 2008, in Chapter 2, Steven Rosefielde argues that the imprudence of US policymakers in prioritizing the short-term economic prosperity through financial deregulation, deficit spending and lax monetary policy facilitated the onset of the crisis. Historically, after the Great Depression, achieving full employment became one of the key political priorities of the U.S. government. In the 1950s, Keynesians such as William Phillips and Paul Samuelson popularized their view that full employment could be achieved through fiscal stimuli and accommodative monetary policies. From the 1960s, beneficiaries of these stimulus policies were mainly big firms and banks who enjoyed consistent speculative profits thanks to numerous deregulatory measures. Although policymakers observed early warning signs from the bust of the dot-com and 2006 housing bubbles, the expansion of GDP coupled with low unemployment justified their belief that financial deregulation, including the spread of subprime mortgages and derivatives would contribute towards sustainable long-term economic growth. As a result, policymakers continued to hold on to the belief that the cost of averting deficit spending and strengthening regulations outweighed the possible dangers of future crises. Rosefielde argues that in
order to break the persistent pattern of deficit spending and weak regulation, there needs to be a
government-monitoring agent such as a “the Bubble Prevention Authority,” charged with
supervising speculative bubbles and preventing future “irrational exuberance”.

Steven Rosefielde, in Chapter 7, also argues that global imbalances indirectly fostered the financial
crisis in 2008 by encouraging the excessive build-up of credit and the short-termist government
policies. ‘Global imbalances’ refers to concentration of debt in certain countries like U.S. and
excessive savings in other countries like China. Since 1986, through mercantalist policies that
courage over-exporting of Chinese goods by undervaluing the Yuan, the Chinese government was
able to accumulate US dollars in its foreign reserve. These reserves have been channeled into
Treasury Bonds helping finance U.S. deficit spending over the past decade. This continued high
demand for U.S. treasury debt from China kept the interest rate on Treasuries low, which pushed
investors to seek higher yields elsewhere which stimulated the build-up of speculative bubbles in
hard asset markets like real estate. Furthermore, heavily-subsidized export goods from China put
downward pressure on prices of domestic American goods which had to compete with cheap
Chinese imports. Global imbalances helped prevent inflation and interest rates from rising, and
therefore allowed the American government to pursue deficit spending and encouraged a belief in
“divine coincidence”: (chapter 7, p.161) the view that stabilization of inflation through a single
instrument, namely, the short-term interest rate, could result in steady output.

Jonathan Leightner, in Chapter 8, discusses external, and potential internal, crises that can result
domestically from global imbalances. He illustrates alternative ways to prevent such crises with the
example of China. Chinese export-led growth made China vulnerable to external shocks in U.S.
demand. At the same time, the fall in the value of the dollar, caused a financial losses for
China, since 70% of Chinese foreign reserves are dollar denominated, and increased the inflation
rate in China because the yuan is fixed to the dollar and the dollar price of commodities such as oil
and ore rose. (Chapter 8, p.180) According to the author, in order for China to fight inflation, the
Chinese government needs to decrease the money supply, which in turn will increase the domestic
interest rate. The rise in the domestic interest rate, however, could cause massive international
capital inflows, which could cause dangerous speculative bubbles within China.

Leightner suggests that the Chinese government needs to gradually reduce its dependence on the
“Export-Driven Growth Model,” and to adopt the “Consumption Growth Model,” in order to avoid
future external and internal crises. To achieve such a transformation, the Chinese government has to
turn to alternative buyers of its output, that is, its domestic market. However, many Chinese people
do not have sufficient purchasing power because of severe income inequality. Moreover, the lack of
adequate public safety nets motivates Chinese people to save rather than spend their income since
they cannot trust the public pension and health care system. Hence, the Chinese government needs to
implement policies that can protect workers from exploitation by their employers and to widen and
improve service delivery.

While the book, Prevention and Crisis Management, offers insightful analysis on how policymakers
failed to prevent, and actively facilitated the excesses that led to the crisis, it fails to provide
satisfactory analysis on the role played by the private sector. Practices of predatory lending by
mortgage lenders, for example, contributed to the provision of highly risky subprime mortgages
among vulnerable households. David K. Musto, Professor of Finance at the Wharton School,
describes predatory lending as lending that reduces the expected welfare of borrowers, or lending
with high possibility of default by borrowers. Why would a rational borrower want to have such
mortgage? Musto claims that asymmetric information about the default rates between borrowers and
lenders, and a lack of competition in the mortgage market allowed lenders to engage in predatory lending. In general, lenders have more private information on the possibility of foreclosure thanks to their experience in handling numerous customers. Borrowers, on the other hand, do not usually have full information about their chances of default. In some occasions, lenders may even suggest risky subprime mortgages to creditworthy borrowers in order to maximize their commissions. (Bond et al., 2008; Knowledge@Wharton., 2008)

Likewise, although Leightner provides a strong and insightful argument for why the Chinese government needs to endorse a consumption-driven growth model, China may face significant costs in the process of adjustment, such as ‘creative destruction’ among export-oriented companies (Patrick, 2011). The analysis would have been even more thorough if he also considered what the potential costs might be and what actions the Chinese government might need to take to mitigate such costs in achieving the transformation.

In conclusion, Prevention and Crisis Management draws the lesson from the crisis that economic booms need to be carefully monitored especially when they result from deficit spending, expansionary monetary policies, financial deregulation and mercantilist trade policies. Have we learned the lessons? Steven Rosefielde adds that merely imposing stronger financial regulation and modestly tightening the short-term budget will not prevent recurring crises. Instead, a more comprehensive solution should include structural reform of governance and establishment of monitoring agencies that oversee speculation and potential bubbles. As the world becomes more interconnected and China rises as the second largest economy in the world, future financial crises may be more complicated and have even bigger impacts on the global economy. Overall, measures for preventing and managing crises should consider not only domestic circumstances, but also global imbalances.

References


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