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PUBLIC POLICY FOR THE PRIVATE SECTOR

Dealing with the Crisis

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This is the first in a series of policy briefs on the crisis—assessing the policy responses, shedding light on financial reforms currently under debate, and providing insights for emerging-market policy makers.

Taking Stock of the Global Policy Response

The immediate financial sector policy responses to the financial crisis—including emergency liquidity support, expansion of financial safety nets, and interventions in financial institutions—have succeeded in stemming widespread panic. But the effort has generally been insufficient and ad hoc. Issues that remain include the resolution of problem assets, the restructuring of troubled, systemically important financial institutions, and the development of credible exit strategies. Only a handful of countries have attempted to tackle these issues head-on. As past experience has shown, that may well have negative repercussions for the duration and strength of a subsequent recovery.

The financial crisis is upon us, and its duration is still unknown. We are well past what might be considered the first two stages (the U.S.-subprime-mortgage-cum-structured-finance debacle and the post-Lehman global financial market turmoil) and have moved to the third and final stage (worldwide economic recession). Compared with previous crises, this one is deeper and wider, reflecting the growth in financial penetration and globalization in recent decades.¹

While observers disagree about the relative importance of different contributing factors, it is generally accepted that the crisis stemmed from a combination of unsustainable global macro-economic imbalances and structural financial system weaknesses in the context of excessively loose monetary policy, abundant liquidity, rising

asset prices, and increased financial innovation and globalization. These factors bred complacency and led to underpricing of risks by market participants and regulators, resulting in increasingly riskier strategies and the buildup of systemic vulnerabilities.²

Unlike recent episodes, this crisis originated in developed countries and has spread to emerging-market economies through a range of financial and real sector channels. While the crisis first emerged in the U.S. subprime mortgage market, poor policy responses have probably contributed to its propagation—with a widely cited example being the decision by the U.S. authorities to allow the failure of Lehman Brothers in September 2008. The worldwide economic recession has added even more—especially nonfinancial—channels of transmission.



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Policy responses in developed countries

As recent events have shown, important weaknesses remain in crisis preparedness and contingency planning arrangements both within and across borders. Key needs include assessing risks to the financial system (including through stress testing and crisis simulation exercises), identifying key counterparties (both within and across countries) and developing coordination protocols, reviewing the authorities' legal powers and resources, and adopting an appropriate crisis and communication plan. Although these needs are not new, they have once again come to the fore. The speed with which the crisis has spread means that the development of such arrangements has come too late for several countries, leading to ad hoc and inconsistent policy responses.

As with previous crises, the immediate financial sector policy responses have sought to stem panic among market participants and the wider public and to restore financial stability.³ Five types of measures have been undertaken, often sequentially:

- Provision of emergency liquidity support (not discussed here), typically by easing access to central bank “lender of last resort” facilities, establishing foreign exchange swap facilities, and lowering reserve requirements
- Expansion of financial safety nets
- Interventions and capital injections in financial institutions
- Financial institution restructuring and problem asset resolution
- Measures to kick-start lending

Expanding financial safety nets

Prompted by systemic stability and, in a few cases, competitive concerns, most high-income countries have provided extensive assurances to depositors and creditors of banks and, in a few cases, to those of nonbank financial institutions. Some of these arrangements include blanket guarantees on deposits and guarantees on (mostly new) bank debt issues in order to maintain funding, restore investor confidence, and buy time for other policy measures to take effect. The guarantees are unprecedented in scale and reflect a paradigm shift from the traditional role of preventing bank runs by small, uninformed depositors. Although some countries initially announced that the guarantees

would be extended for 18–36 months, they are likely to be maintained until financial stability is consolidated and credit flows resume on a sustained basis, which may take longer.

The design and scope of such guarantees vary widely across countries. Two essential conditions—their proper pricing and the parallel introduction of credible policy measures to clean up the banking system—have not always been met, leading to such distortions as the implicit subsidization of weaker banks and the crowding out of nonguaranteed forms of debt issuance. In addition, the crisis has shown the need for much greater international policy coordination in adopting and suspending such guarantees to avoid inefficient beggar-thy-neighbor outcomes. While such coordination generally was not critical in earlier crises, today's global interconnectedness makes it imperative.

Some of the announced changes to the design of deposit insurance schemes may become permanent. In addition, the size of such schemes, especially their inability to cover the costs of large failing banks, is likely to be reviewed. But the central question is whether safety nets will be credible after the new guarantees are suspended. The potential lack of credibility and the associated moral hazard are likely to impose a heavier burden on financial regulation and supervision.

Recapitalizing financial institutions

Spurred by increases in write-downs and credit losses, the United States and several European countries have pursued bank intervention strategies that have included arranged takeovers of weaker entities by stronger partners (Bear Stearns, HBOS, Wachovia), conservatorship (Fannie Mae, Freddie Mac), closures (Lehman Brothers, Washington Mutual), and nationalizations (Northern Rock, Bradford & Bingley). These countries have also provided significant capital injections to other private financial institutions to prevent breach of minimum prudential requirements. These were initially ad hoc responses to rescue specific institutions—perceived by market participants to be at imminent risk of failure—in the belief that the overall financial system remained fundamentally solvent. Later, however, especially from late 2008 on, such interventions took the form of industry-wide support packages. In some cases they have led to the government

becoming the main shareholder of still-private financial institutions (AIG, Citigroup, Royal Bank of Scotland).

The preference has been for injections through the issuance of preferred shares, although these will be converted to common shares carrying full voting rights if continued losses wipe out financial institutions' equity positions. Some of the injections have been criticized for lack of transparency and accountability, for inconsistency across institutions and countries, and for lack of a rigorous assessment of the financial institutions' viability and true capital needs. Equally important, they raise fundamental issues of fairness because they expose taxpayers before creditors to mounting financial institution losses, allegedly to prevent any adverse systemic knock-on effects. As a result, there is a danger that governments will prefer to keep "zombie banks" operating and profitable so as to minimize (short-run) losses to taxpayers and avoid the negative externalities associated with the banks' closure.

Government exit plans are defined in only a handful of programs and are conditional on the recovery process. Participation in these programs increasingly involves conditions on board representation, executive compensation, and profit distribution. Some countries (such as the United Kingdom) have introduced particularly strict conditions that include significant shareholder dilution and changes to board composition; others (such as the United States) have mostly avoided such measures so far. The programs also differ in objectives, with some explicitly setting loan growth targets to prevent a potential credit crunch while attempting to avoid political interference in bank operations—a difficult if not impossible balancing act. For EU member states, the European Commission has attempted to limit potential competitive distortions arising from such programs by introducing a set of rules to govern them (see European Commission 2008 for details).

The deepening recession may force some countries to nationalize (de jure or de facto) even more of their domestic banking system. While unthinkable until a few months ago, such a step may ultimately be the only way to limit rising bank losses, resolve the asset valuation problems (see below), protect taxpayers, and convince market participants of the government's unconditional

support as an "investor of last resort." In taking such a step, policy makers need to develop an institutional framework for governing banks in the transitional period, ranging from an autonomous agency to bank restructuring units within the ministry of finance or central bank. Adhering to good corporate governance practices and commercial principles would help the government maximize the value of its investments and bring forward the time of exit.

Dealing with problem assets

Several countries have announced programs to deal with exposures on bank balance sheets. Most of them target higher-quality assets and thus do not specifically attempt to clean banks of their problem exposures. These programs involve either a government guarantee on certain types of loans while keeping those loans on bank balance sheets or the purchase of a broad range of structured securities and loan portfolios. Approaches differ widely and result in different ex ante allocations of losses between bank shareholders and taxpayers, although their effects can be fully assessed only when the crisis has been contained.

Only a few countries have attempted to tackle problem assets head-on. The United States recently announced the Public-Private Investment Program through which the government will provide cofinancing and guarantees for private investors to purchase troubled assets (both loans and securities) from banks. Germany announced a plan to segregate toxic assets in separate vehicles within each bank using public guarantees. Ireland intends to establish a single, industry-wide "bad bank" to take over the problem loans of Irish banks. A few other countries have moved such assets into separate vehicles as part of an attempt to clean up domestic banks (as with UBS in Switzerland).

While these types of financial engineering may improve banks' liquidity and creditworthiness, they do not necessarily promote efficient resolution of problem assets. Different workout approaches, centralized or decentralized, can be pursued regardless of which measures are adopted to restore bank solvency and liquidity. Many emerging and a few high-income economies are familiar with the issues, having faced large-scale restructurings and workouts in the 1990s.

But in the current crisis, unlike in previous ones, most of the distressed assets have been structured securities (rather than corporate debt) and thus difficult to unbundle and restructure.

If unbundling proves to be impossible, the alternative may be to separate the pools of problem assets into distinct vehicles (legally or through guarantees) and allow the assets to essentially run off. The problem with this is twofold: valuation of the assets at the time of transfer and the implications for banks' capital adequacy. The customization and extreme market illiquidity of such assets make valuations difficult without detailed—and time-consuming—audits of the characteristics of the underlying pool. The debates on fair-value accounting and on establishing auction mechanisms for such assets stem largely from this problem, which will help determine the size and allocation of losses from their transfer. Since valuations are likely to result in greater losses for banks at the time of transfer, substantial additional capital injections may be needed—one reason this method has not been widely used in the crisis thus far. The governance structure and risk sharing profile (that is, the sharing of the upside between government and private participants) of any “bad bank” vehicles will also be contentious.

Unfreezing lending

Evidence of a credit crunch remains mostly anecdotal, although credit growth rates have plunged around the world. While research on past crises shows that output tends to recover before credit,⁴ a healthy financial system is needed to promote a sustainable economic recovery. Capital injections may partly restore banks' financial health, but the worsening outlook understandably makes banks cautious about new lending. At the same time, demand for bank financing has increased in some countries as a result of the implosion of the “shadow financial system” and the drying up of liquidity and risk appetite in capital markets. These pressures are beginning to lead to the crowding out of smaller and riskier borrowers in countries where governments and large corporations that were funded in capital markets are reverting to banks for their financing needs.

Central banks have stepped into the void by, for example, adopting credit easing policies or

releasing foreign exchange reserves to kick-start financing in credit markets. Their unconventional, quasi-fiscal tactics, sometimes forced on them as policy rates drop to zero and political deadlock and fiscal inflexibility constrain governments, will be closely scrutinized for their effectiveness and their impact on inflation objectives.

The crisis has led some countries to abandon orthodoxy and adopt whatever policy levers are at their disposal to ease the credit crunch. These have included additional lending by state-owned financial institutions, the provision of credit guarantees and lines of credit, and even direct government support for troubled borrowers (such as the car industry). All this is rekindling old debates about the desirability and usefulness of state intervention in the financial system.

Policy responses in emerging economies

The risk aversion and deleveraging that followed the collapse of Lehman Brothers in September 2008 led to a global reversal in capital flows and hit emerging-market economies particularly hard. The outflows led to significant—and sometimes indiscriminate—financial market sell-offs, higher interest rates and spreads, and pressures on exchange rates. These created negative feedback loops and raised fears (not yet realized) of “sudden stops”—the abrupt reversals in the availability of foreign credit characterizing recent financial crises in emerging economies.

The channels of contagion differ widely across countries. The crisis has revealed preexisting homegrown problems ranging from large external deficits and overvalued currencies to lax credit underwriting standards and maturity and currency mismatches on bank and corporate balance sheets. Adopting a “one size fits all” explanation of the propagators of the crisis—or, by implication, of the different policy responses adopted in these countries—would therefore be inappropriate.

Several of the crisis management measures discussed have not (yet?) been necessary for most emerging economies. Review of a sample of emerging economies shows that emergency liquidity support to the domestic banking system has been the main policy response, followed by the expansion of safety nets and measures to kick-start lending (table 1). Those that were

Table Crisis-related policy measures announced by selected emerging economies by April 2009

1	Emergency liquidity support	Increased deposit insurance coverage	Guarantees on bank debt	Capital support	Troubled asset purchases or guarantees	Measures to kick-start lending
East Asia						
China	✓			✓		✓
Indonesia	✓	✓				
Korea, Rep. of	✓		✓	✓	✓	✓
Malaysia	✓	✓				✓
Philippines	✓	✓				
Thailand		✓				✓
Vietnam	✓					✓
Emerging Europe and Central Asia						
Bulgaria	✓	✓				
Croatia	✓	✓				✓
Czech Republic	✓	✓				
Estonia	✓	✓				
Hungary	✓	✓	✓	✓		✓
Kazakhstan	✓	✓	✓	✓		
Latvia	✓	✓	✓	✓		
Lithuania	✓	✓				✓
Poland	✓	✓				✓
Romania	✓	✓				
Russian Federation	✓	✓	✓	✓	✓	✓
Serbia	✓	✓				
Slovak Republic		✓				
Slovenia	✓	✓	✓			
Turkey	✓	✓				✓
Ukraine	✓	✓		✓		✓
Latin America						
Argentina	✓					✓
Brazil	✓					✓
Chile	✓					✓
Colombia	✓					✓
Mexico	✓		✓			✓
Peru	✓					✓
Middle East						
Jordan		✓	✓			
Kuwait	✓	✓	✓		✓	✓
Qatar				✓		
Saudi Arabia	✓	✓	✓	✓		✓
United Arab Emirates	✓	✓		✓		
South Asia						
India	✓			✓		✓
Sub-Saharan Africa						
Nigeria	✓					
South Africa	✓					

Source: World Bank; International Monetary Fund; Fitch Ratings; BNP Paribas.

less financially integrated (such as Sub-Saharan African countries) or that had stronger macroeconomic and financial system fundamentals (such as Latin American ones) have generally been less affected.

A few emerging economies—particularly in emerging Europe and parts of the Middle East and East Asia—have attempted to match developed countries by increasing deposit insurance coverage and introducing blanket guarantees so as to prevent capital outflows or destabilizing bank runs. But the state guarantee is unlikely to be credible in countries with sizable public sector debt, a large banking system, and an open capital account. A few countries have also introduced selective controls on capital outflows, and more may do so as they try to prevent “leakages” of domestic liquidity injections or find themselves unable to cover external financing needs. As past experience has shown, such tools may have short-term success in stemming outflows but long-lasting adverse effects on domestic deposit mobilization.

Capital support has focused mostly on expanding the equity base of state-owned banks as a way to increase lending (China, India), as a preemptive measure (Qatar, Saudi Arabia), or as a means to address troubled financial institutions (Russian Federation, United Arab Emirates). There have been relatively few instances of banking-system-wide problems due to a significant accumulation of nonperforming loans. But the continuing sharp declines in economic activity and the large refinancing needs of corporations (financial and nonfinancial) in some emerging economies are likely to create bank funding and solvency problems and generate corporate restructuring needs that will ultimately require support from governments and the international community.

In many emerging economies the crisis has manifested itself mainly through terms-of-trade and investment (rather than financial) links, including drops in commodity prices, remittances, and foreign direct investment. Its global nature will make it difficult for economies to grow their way out through higher exports as in the past. The pressures are particularly severe for countries that have relied on capital inflows to expand economic activity and domestic financ-

ing. Government support programs in developed countries that set domestic lending targets have had the unintended consequence of reducing cross-border lending (such as trade finance) and accelerating domestic banks’ retrenchment from foreign activities.

Finally, in emerging economies, as in developed ones, deleveraging is leading to the crowding out of riskier borrowers, particularly small and medium-size enterprises. Thus it is no surprise that emerging economies have adopted a range of measures to avoid a credit crunch. The duration of this external shock will largely determine whether such measures are more appropriate than adjustments in the economic structure.

Conclusion

The immediate financial sector policy responses by developed countries—including emergency liquidity support, expansion of financial safety nets, and interventions in financial institutions—have succeeded in stemming widespread panic. Few emerging economies outside of emerging Europe have needed to adopt most such responses so far, although policy makers around the world have taken measures—including unconventional ones—to ease the perceived credit crunch and kick-start lending.

We still have not exited from the crisis, so a full assessment of the policy responses remains tentative. As with previous crises, however, the depth of this one has been consistently underestimated and initial policy measures have been ad hoc and insufficient given the magnitude of the problems. Issues that remain unsolved—the “known unknowns”—include the resolution of problem assets, the restructuring of troubled, systemically important financial institutions, and the development of credible exit strategies. Only a handful of countries have attempted to tackle these issues head-on. As past experience has shown, that may well have negative repercussions for the duration and strength of a subsequent recovery.

Equally important, some measures, such as those that have shielded troubled financial institutions from the full brunt of market forces, are at odds with the policy advice promulgated by developed countries in the past. That raises legitimate questions among emerging-market policy

makers about double standards. Whether this perception will change by the time the crisis is fully contained remains to be seen.

Notes

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1. Banking crises are quite common and tend to follow periods of high international capital mobility; see Reinhart and Rogoff (2008) for a historical overview.
2. For analysis of the causes of the crisis, see Acharya and Richardson (2009); Brunnermeier (2009); FSA (2009); and Hellwig (2008).
3. See IMF (2009) for a summary of crisis response measures in G-20 countries.
4. See Calvo, Izquierdo, and Talvi (2006) for a description of the “Phoenix miracle” for emerging economies.

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