*Financial and Economic Review, Vol. 15 Issue 3., September 2016, pp. 127–130.*

# Lessons of the financial crisis*

*Dániel Felcser*

*Martin Wolf:*
*The Shifts and the Shocks: What We've Learned – and Have Still to Learn – from the Financial Crisis*
*Penguin Press, 2014, p. 465*
*ISBN-13: 978-1594205446*

In his book, Martin Wolf, chief economics commentator at the Financial Times, seeks to explore how the global financial crisis has changed our views on the economy, the ways we think about economics, and the economic policy. The author provides insight into the fundamental changes and complex interactions between the global economy and the financial system before the crisis and explains how these factors eventually led to the shocks which were experienced.

One of the central themes of the book is the fragility of the financial system and how this inherent fragility escalates from time to time. The author suggests that the increased fragility observed during the crisis was driven by a number of fundamental shifts in the global economy. He identifies three such major changes: the liberalisation of the economy, especially in finance, the technological transformation manifested in the advancement of the information and communication sectors, and the ageing of populations. These underlying factors drove significant changes such as the development of a liberalised and innovative global financial system, rising inequality within individual nations and a massive increase in international capital flows. On balance, the world witnessed an unprecedented shift toward a more market-oriented, financially driven and globalised world economy.

Explanations abound regarding the root of the global financial crisis. It is important to stress that it was not a fiscal crisis, but (perhaps with the only exception of Greece) a financial crisis with fiscal consequences that affected major financial centres worldwide. Early signs of the crisis surfaced in the summer of 2007 and escalated in autumn 2008. Only the globally coordinated action of governments and central banks was able to halt the ensuing panic. Despite the unprecedented policy response, recovery in the high-income countries was disappointing, while

* The views expressed in this paper are those of the author(s) and do not necessarily reflect the offical view of the Magyar Nemzeti Bank.

*Dániel Felcser is a senior analyst at the Magyar Nemzeti Bank. E-mail: felcserd@mnb.hu*

the emerging economies, in general, managed to grow. This generated a shift in the global economy as previous centres are becoming more peripheral.

Central banks and fiscal policy both helped the economies to recover. If fiscal policy had refused to accumulate the fiscal deficits stemming from the economic downturn, the ensuing recession would have been even more devastating. Wolf argues that policymakers' premature rush back to fiscal austerity delayed the recovery and hindered monetary policy. At the same time, the financial system's reliance on the state can no longer be ignored and the era of financial liberalisation is over, warns the author.

There are numerous lessons to be learnt from the crisis regarding the financial sector. Firstly, the financial system is inherently fragile and vulnerable to panics. Secondly, the widely held view that stabilising inflation will bring economic stability has been proven incorrect. On the contrary, it is precisely in times of economic stability – when economic participants are more prone to take greater risks – that the financial system becomes more fragile. Finally, policymakers failed to come up with a firm response until the crisis hit its trough. The lax policies preceding the crisis were rooted in the assumption that participants had a vested interest in the stability and the efficiency of the financial system. Subsequently, crisis management found itself torn between two conflicting ideas: should it go to the rescue of ailing financial institutions or was it ill-advised to intervene, in view of the moral hazard? Dealing with moral hazard, the author notes, is like the job of the fire service: you cannot let any building burn down as the fire may spread to people who had nothing to do with starting it in the first place. A financial crisis should be addressed similarly: finances are also in need of fire brigades, regulations and insurance.

Aware of its importance, societies around the world apply various methods to prevent the collapse of the banking system in times of crisis. Governments seek to improve the safety of banks, but banks are profit-oriented, risk-taking institutions. A more robust financial system could have helped crisis management, but the crisis also revealed some unsustainable economic processes, in light of which the global economy cannot return to its pre-crisis state. In addition, the crisis called into question a central tenet of free market economies: that the rational pursuit of self-interest delivers stability. In Wolf's opinion, this crisis was a crisis of conventional macroeconomics as well, as it emanated from the system itself. Therefore, a "new normal" is called for.

While the post-crisis policy consensus preserves the globally integrated economy and financial system, it also recognises the threats. Accordingly, it adds macroprudential supervision and more financial regulations to the existing inflation targeting monetary policy. By contrast, various alternative theories hold different views on economic roles and trends, but tend to agree on one specific point: that the balance between the state's role as the supplier of money and the private sector's role as the creator of credit and money is highly destabilising. Based on this consideration, they anticipate a more pronounced segmentation of the world's financial system.

The crisis spawned significant regulatory changes, of which two measures are of key significance: the increased capital adequacy requirement and a macroprudential framework focused on the resilience of the financial system as a whole. The augmented regulations, however, have become extremely complex. In any event, points out the author, the financial system will collapse over time despite regulation, as fragility is an inherent feature of the system. Regulations notwithstanding, societies permit some activities that are not perfectly safe (e.g. flying). As regards finances, however, two aspects should be borne in mind: the enormous negative externalities and the substantial economic and social costs of financial crises.

The crisis is coupled with uncertainty surrounding the future of the euro area. After the Greek debt crisis, the epicentre shifted to the euro area. The structure of the euro area is an interim solution where Member States are not independent and currency arrangements are more credible than traditional, fixed exchange rate regimes, but it does not benefit from the automatic risk-pooling mechanisms of modern federal states. As an important lesson of the crisis, changes in the balance of payments remain relevant in the Monetary Union as well. While free capital flows are commonly cited among the benefits of the Monetary Union, countries with current account deficits were unprepared for the sudden reversal of capital flows. Although economic globalisation yielded a number of significant results, such as the integration of China and India into the global economy and the reduction of poverty in several developing and emerging regions, the globalisation of debt generating capital flows had no such advantages, points out the author.

According to Wolf, the crisis underlined the precariousness of a monetary union that is composed of different economies and diverse cultures. Compared to the United States, the economy of the euro area is less integrated and the institutional-political fundamentals are weaker. Another critical point is the fact that break-up is not an option in the case of the US. The euro area needs to carry out a symmetrical adjustment to restore the balance; in other words, countries with current account surpluses should also strive to alleviate imbalances. A solution should be found for financing the economies that face financial difficulties and for addressing the debt overhang. Finally, further progress is needed in key economic policy areas.

Over the long run, the health of the economies and the sustainability of growth should be put in focus. In the author's view, in addition to improving the resilience of the financial system and alleviating global imbalances, there is also a need to preserve the useful elements of the open global economy and integrated finances. Essentially, economies must do everything in their power to prevent crises in the future. It remains to be seen how far the world should go beyond the new economic policy consensus to reach this goal. It depends on the recovery of the economies and on the magnitude of the risks that they are willing to take.