GLOBAL FINANCIAL CRISIS: ROLE OF INTERNATIONAL INSTITUTIONAL FRAMEWORK, AND LESSONS FOR TRANSITIONAL COUNTRIES

RADISLAV JOVOVIC,
"Montenegro Business School", Mediterranean University
Podgorica, Montenegro

Abstract
As the global financial system has become increasingly interconnected, the global institutional framework plays the important role in international financial system stability. The role of international institutions, first of all IMF have been criticized as being less than fully effective, too focused on bilateral issues, and not fully accounting for the risks of contagion that have been seen in the recent crisis. This paper discusses roles of international institutional framework in helping to avoid a future global financial crisis.
The following appears to catch particular attention in this paper: a) How to improve Instituting a macro prudential approach to supervision and assigning a clear mandate to a systemic stability regulator; b) How to expand the perimeter of financial sector surveillance to ensure that the systemic risks posed by unregulated or less regulated financial sector segments are addressed; c) How to ensuring that prudential regimes encourage incentives that support systemic stability and discourage regulatory arbitrage, and assure effective enforcement of regulation. The author expects that this paper will catch attention for finding solutions for above cited questions.
In this framework the author will try to draw up lessons of the financial crisis for developing future financial institution architecture, and to analyze impact on transitional countries.

***Key words**: Financial Crises, Financial Regulations, International Institutions, Global Economy, Subprime Mortgage.*

JEL Classification: F 00; F 30;
Review
Received: April 14, 2012 / Accepted: June 28, 2012

1. Introduction

I recognized need for such an article. It is professional need, and challenge. I think that economist researchers have to fully engage in finding solutions in time of a great crisis. Today, the world is faced with tumultuous economic changes, with great uncertainty. It is obvious that economic science sometimes hasn't followed economic life such as during the last years. There are a lot of papers, and books, which explain the new economic phenomena, and research the recent economic crisis with ambitions to be proactive, and contribute making good solutions. But some things miss and stay unclear. My ambitions is directed toward not only considering causes of crisis but also toward developing system approach which allows the enough generalization to provide holistic view of the crisis on the global level, and understand role of development of international institutional framework. Smich (2008, p. 5) warned at the beginning of the recent financial crisis that "*every person today would be socked to know how much the global financial system, though robust, face a potential risk to its own survival. It is vulnerable to a psychological hard effect that could wreak havoc with the industrial world economy*". Unfortunately, after long

lasted financial crisis many governments have been shocked. Obviously, the crisis has complex, deep, and long lasted consequences. That indicates tectonic distortion in the world economy!
This article is effort of the author to discover what is behind details, and facts of everyday manifestation of economic life in order to systemize knowledge that will help to all players (especially to transition economies) to cope with uncertainties that could affect all of them which are tie with tectonic distortions. Uncertainty destroys soul, and hart of human beings and because of that, it has negative influence on economic decisions. The world must find the best approach to changes, especially specific changes, which are always treat to economic prosperity.

The economic life doesn't stand in. Instead, it continues to change dramatically. The main catalyst of changes in economy is globalization boosted by digital technologies which shortened the distances between countries, and revolutionized the global supply chain (Fridman). A new space has opened for business through virtual endless market, and permits people to engage in business with one another across the globe. This change is challenge, not only for developed countries, but also for transition countries. Dynamism, followed by uncertainty, and incomplete information are dominant characteristics not only market of goods but also of financial markets. During last years "*we are always being surprised, and that is why world has become such a dangerous place*" (Smich, p. 2). It is obvious that changes will accelerate! And crisis could have been destiny of the world economy.

The recent financial crisis that originated in the United States of America has become a catalyst for global crises. Economies, particularly the emerging markets, found they had become dangerously dependent on gluttonous, debt-ridden American consumers, who lost their power to buy. Ugly development culminated into destruction of a globally interconnected banking system.
Additionally, except examining the recent financial crises, the paper focused on issue institutional architecture in the world finance. Based on this analysis, one may answer the question as to whether the financial regulations proposed by the United States, and other countries, are appropriate for the new economic order?

2. The recent financial crisis

Examining available literature, and facts, we found many causes of the crisis, but as the greatest factor was the housing babble. Housing prices declines dramatically, with unprecedented in its scale. The problem culminated in loosing consumers power to buy. But, it started with housing babble. Existing home sales and inventory before ana after bubble are shown on figure 1. Subprime mortgages were important part of this initial story. The newly-designed financial instruments were created, such as CDOs (Collateralized Debt Obligations) and MBSs (Mortgage Backed Securities) with ambition of banks to meet the high demand for mortgages. CDOs provided a way to spread risk away from the original securities so that the banks providing sub-prime mortgages became disassociated with the risk they created. These unregulated securities were often based on subprime mortgages. Figure 2 shows the dramatic drop of mortgage backed securities following the burst of the housing bubble as people could no longer afford to pay their mortgages. Out of the eighty-million houses in the U.S., about fifty-five million had mortgages. Of those fifty-five million, four million were actually behind on their payments.

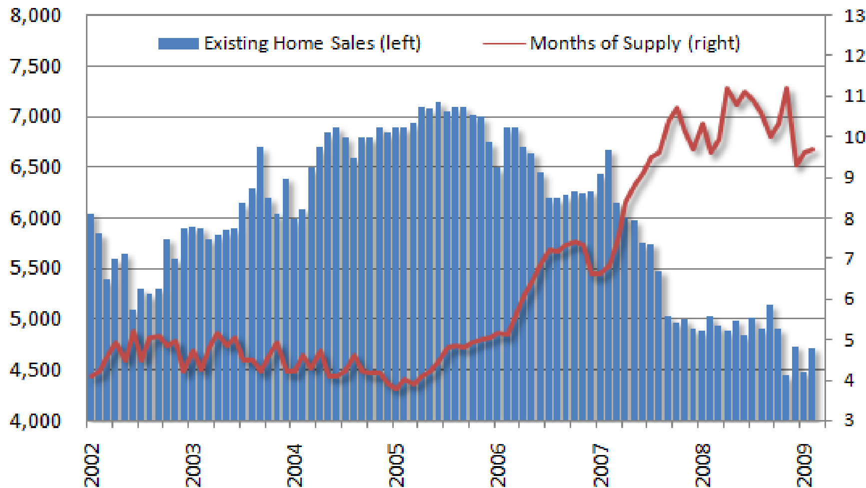
3. Financial markets become internationalized

This housing babble occurred in the circumstances of connected global financial system.
Process of globalization is usually recognized as information, and communication technologies spread all over the world, and connected through "the network of all networks" – Internet. The picture of globalization usually doesn't show financial market traders' or trillion dollars moving around the globe. But how did all these amazing technological development come about? The author agreed with Smich's opinion that the answer lies in looking the way financial markets become internationalized. Financial markets are what got globalization started. It stated happening since 1990s when national capital began to leave homes. Instead of private pools of each country's capital, stated creation of global pool of capital. The difference between old and emerging

capital market is huge. The financial markets before globalization were simple, sleep, inefficient, and relatively productive for policymaker. Unfortunately, this system enjoyed relatively limited means of financing entrepreneurial initiative, and assessing new investment risk.

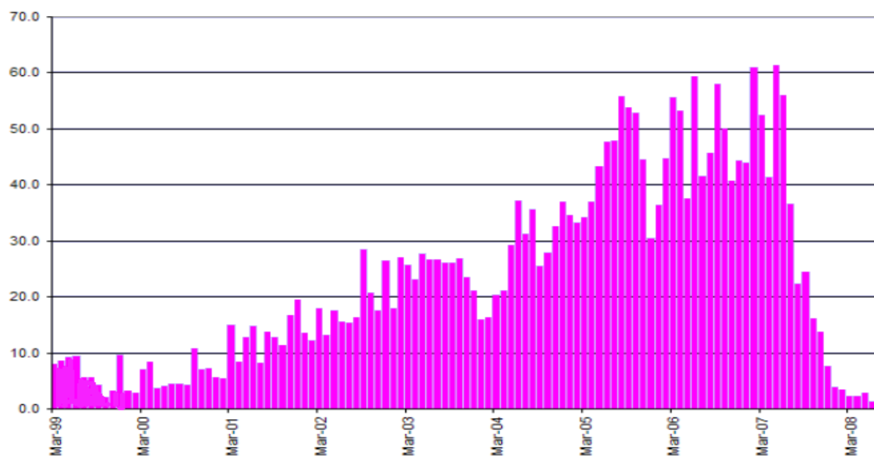
Figure 1: Existing Home Sales and Inventory

Seasonally Adjusted Annual Rate in Thousands, Source: NAR



Source: Iacono (2008),

Figure2: US Issues of Non-Agency MBS ($billion)



Source: Twiggs (2008), taken from Shachmurove

Since 1979, new financial vehicles were unleashed into market. First of all venture-capital financed by pension funds. The venture-capital industry was financed 44% from pension funds between 1980, and 2001. Extraordinary development in the freeing up and deploying of financial capital was based on:

- Rejuvenation as private and public pensions, and other financial mechanisms:
- Congress termination the regulations capping the interest rate paid on saving accounts;
- Lessening the amount of capital that banks were required to keep in reservs;
- Cutting capital gain rate.

By mid-1980s, liberalized U. S. financial markets were feeding capital into international capital loop, by using a diverse range of financial tools: private equity funds, private debt placements, hedge funds, high-yield bonds, venture capital funds, turnaround funds, and private mezzanine investing. Banks and investment houses in New York, London, Tokio, Paris and Frankfurt were being internationalized for one other reason. Advances in communication and computer technologies create sense that “capital was no longer confined to separate lakes or pools but had combined into a massive, borderless ocean of money (Smich, p. 43). The peace of deregulation accelerated. Capital started flowing from country to country, followed by massive surge in the global trade of goods and services.

4. Securization, and spreading the crisis

The bubble from United States has spread fast all over the world thank to free flow of capital on internationalized financial markets. Of course, the bubble is the most apparent cause of the crisis, but there are many others. Beside the bubble, United States had a large trade deficit. Besides the large deficit stay vast sums of foreign funds were invested in the United States. This fund was invested by foreign firms, and governments (China, Russia, and other). When the crisis occurred, the money invested by foreign firms and governments was lost, adversely affecting these companies. Therefore, losses spread to other countries.

Moreover, Geithner estimated that forty percent of total U.S. Bank assets were in “Shadow Banking,” or non-bank lending institutions that were not federally controlled (2010). “This explains the extent of the bubble as financial institutions attempted to seek small spreads with significantly increased risk.” (Shachmurove, p. 13). The problem here is lack of transparency, with existence of off-balance sheet activities of banks, people could not make well informed investment decisions and many lost substantial amounts of money. The turning point from the burst of a housing bubble to widespread financial crisis was the collapse of Bear Stearns on August 1, 2008. What is Bear Stearns? It was one of the largest holders of mortgage backed securities.
The collapse of Bear Stearns on August 1, 2008 marks the turning point from the burst of a housing bubble to a widespread financial crisis. Bear Stearns was one of the largest holders of mortgage backed securities. Bera Stearns lost confidence, and a precipitous drop in its stock price as shareholders rushed to sell their shares. In spite of the support The Federal Reserve Bank to restore confidence in market, it didn’t restored, and soon other holders of mortgage backed securities began to fail. The crisis affected employment, services, other industries. By October 2009, the unemployment rate rose to 10.1%. The entire value of home equity in the United States dropped from $13.3 trillion to $8 trillion, a loss of $5.3 trillion. Investment assets lost $3.5 trillion. Compared to the current United States GDP of $14.26 trillion this is a massive amount of wealth destruction.

In this crisis, in each case, the difficulties originated in lightly regulated financial institutions and instruments.

5. Regulations in USA

The stroke of the crisis was unexpected, and severe. As response to it, first, President George W. Bush signed the Troubled Asset Relief Program (TARP) on October 3, 2008. This program allows the Fed and Treasury to purchase troubled assets from financial institutions in order to increase confidence in the financial sector. However, this program was not successful, and instead became a recapitalization of banks, such as Goldman Sachs and Citigroup as well as other large troubled companies, for example GM and Chrysler. Under the Obama Administration, which took office in January 2009, the government approved an additional $787 billion stimulus package. Moreover, the Federal Reserve dramatically expanded the monetary base through lowering the Federal Funds Rate and quantitative easing, expanding the Federal Reserve’s balance sheet.

While the government handed billions of dollars to various companies, it recently passed the Dodd-Frank Regulatory Reform Bill. Table 1 provides details of the U.S. reforms. This bill

establishes a new body that will protect consumers, the Consumer Financial Protection Bureau. This Bureau will have the power to create rules for any financial entity, including banks, non-banks, and credit unions with assets of $10 billion. This bill gives the United States government more control during periods of impending crises, an important step considering the causes of the most recent crisis (Delaney and Nasiripour, 2010). Paul Volcker, former Federal Reserve Chairman and the current chair of Barack Obama's Economic Recovery Advisory Board also proposed that banks should be restricted in making speculative decisions using taxpayer- backed money (Appelbaum and Cho, 2010). This proposal was signed into law by President Obama on July 21, 2010. Lack of regulations leaded to speculative behavior of banks. The expansionary monetary policy was on the scene.

Table 1: Regulation Changes for United States of America

	Effect	*Proposals Omitted/Defeated*
Consumer protection	Creates a federal regulator to write and enforce rules protecting consumers of financial products like checking accounts, mortgages and payday loans. Increases the authority of state regulators to enforce protections.	Requiring lenders to offer each borrower a “plain vanilla” loan, like a 30-year, fixed-rate mortgage, to illuminate the range of possibilities.
Financial regulation	- Creates a council of regulators to watch for systemic risks. Gives the Federal Reserve new authority over large financial companies. Consolidates banking regulators, merging the Office of Thrift Supervision into the Office of the Comptroller of the Currency. have non- binding vote	- creating a single agency to regulate financial companies. - a single agency to regulate financial markets also never materialized.
Proprietary Trading	Volcker rule Rule – restricts proprietary investing.	-Restoration of barrier between commercial banking and Wall Street trading. commercial banking and Wall Street trading
Investor Protections	-Companies selling complex securities must retain portion of risk -Investors can sue credit ratings agencies.	-Change business model of ratings agencies to remove conflict of interest.
Shareholder Protections	-Executive compensation set by independent directors -Shareholders have non- binding vote,	-Concrete limits on executive compensation -Bonus tax.

Source: New York Times online (Herszenhorn 2010 - adopted)

Given the expansionary monetary policy and the dramatic increase in government debt, the specter of previous high inflation has reemerged. Meanwhile, Central Bank officials maintain that they will be able to raise interest rates and drain liquidity from the system as the economy recovers to avoid inflation. Debts have been increasing as surrogate for declining demand.

6. Global response

As we cited above, the U.S. financial crisis has had significant global consequences. So, the national response to the crisis didn’t enough, the global response arises even more important. For coping with the crisis, the global cooperation has been developed. The intention was to harmonize regulation in order to avoid applying competitive regimes. Without cooperation, the some countries can promote interest to minimize regulations in order to attract investment. In that case, “financial crises are here to stay and another bubble will burst in the future. The only question is when” (Shachmurove, p 14).

The Group of 30 Report (2009) entitled “Financial Reform – A Framework for Financial Stability” calls for the reform of the world financial markets in the following areas.

Financial supervision, its quality and effectiveness need to be globally coordinated and improved. Transparency of financial intermediaries needs to increase.

Capital requirements need to increase taking into account the possibility of catastrophes.

Better monitoring of large institutions and their risk portfolios are required.

These reforms, the Report asserts, will require several years to be implemented due to the complexities of each country's political system. Based on the past experiences, these well-intended global financial reforms will be difficult to actually implement. Despite this call for cooperation, each country needs to implement its own reforms due to different constraints each faces. However, a system for regulating the global financial market needs to be created as well to prevent rash policymaking within individual countries.

While the recent crisis is certainly affecting many of the developed economies, the effects on emerging markets are varied. How these emerging economies behave could determine their place in the future, post-recession economy. Emerging markets have a unique vulnerability to crises originated in the developed economies because emerging markets depend on these economies in order to export their products.

So, it seems that the world is in one bout. The issues of developing new global coordination is on the table, with reconsidering the role of the global institutions.

7. Global Financial Institutions' role

The international economic architecture was established after World War II – the World Bank, the International Monetary Fund and what is now called the World Trade Organization is buckling under the weight of globalization, and changing economic map of the world (for example, rising economic powers in Asia).

The World Bank and its sister institution, the monetary fund, were established in 1944 at Bretton Woods, N.H., to secure the international economy. The bank was supposed to rebuild Europe and reduce poverty elsewhere with grants and loans. The monetary fund tries to avert financial meltdowns by monitoring countries' economic policies. The trade organization, which grew out of the General Agreement on Tariffs and Trade of 1947, seeks to ensure the smooth flow of goods and services that keeps the world economy growing.

Some economists pointed out (Weisman, Stiglich, Krugman) that the role of these institutions is for considering in the light of their relevance in a global economy. The Bretton Woods system has become outmoded," said former Treasury Secretary Robert E. Rubin, member of the board of the Harvard Corporation, Harvard University's executive board. (1997). His opinion is not alone, and author of this article agree with the conclusion that "It has served us very well for a long time, but these institutions haven't changed with the times. They need to be rethought and restructured."

Eckhard Deutscher, a German development official who serves as the dean of the World Bank's directors (2006), called for a re-examination of the role of all the institutions. "The biggest challenge of the World Bank is to restore its credibility," Mr. Deutscher said. "But the international community also needs to look at the whole system. There are governance problems across the board." The most immediate issue the bank and the fund must face, experts said, is who governs them. That means that solutions includes the whole approach (economic, politics, cultural,..). This is paper about economics, but economics inevitably take place in political context (Krugman). In the political context, the political and ideological dominance of capitalism. The recent global economic crisis is certainly testing capitalism, and its institutions.

The recent global economic crisis is certainly testing the ability of the International Monetary Fund to provide sufficient help to affected countries and to demonstrate that the Fund has put its own crisis behind. Therefore, the main question is whether the IMF has fulfilled its role in satisfying the ideals of the Bretton Woods Conference?

It has to be stressed, that although IMF-supported programs are generally focused on crisis resolution, it has been shown that they may also be useful for crisis prevention. Unfortunately,

it is often the case that the national financial authorities are not keen to share independence which they enjoy. It is for this very reason they tend to ask the IMF for its assistance in aftermath of a crisis.

Despite of exceptions, overall the IMF success can be perceived as very limited. It can be argued that although the Fund still satisfies its role of a money lender, it had failed its role with relation to predicting and consequently preventing the economic crisis. When in September 2007 the IMF – the accredited vigilante of the monetary system had issued the Public Information Notice stating that 'given the Irish economy's strong fundamentals and the authorities' commitment to sound policies, Directors expected economic growth to remain robust over the medium term' nobody expected that almost two years later the Nobel prize-winning economist Paul Krugman would have identified Ireland as a model for the worst-case scenario for the global economy.

The world is faced with the big issue: how to build a crisis resilient economic system? This issue isn't new but the recent crisis is the worst since Great Depression, and this issue is unavoidable. "It is good for economic science we now have a lot of data to help interpret what causes crisis and what to do or not to do about them" (Stiglitz, p 321). This paper is focused on at the core problem – bad behavior of the financial system. But financial systems almost always behave badly, so that it is not a surprised. But there is a second part of the problem. Failures of financial sectors, banks and other financial institutions, due to lack of regulations at the level of individual countries and the global economic and financial system. In this paper, we located that financial sector went wrong. But this sector is not separate in the economy. The problem is broader: there is the systemic problem. One thing that economists agree about the systemic problem is that incentives matter, at organizational level and the individual level[1]. "Regarding incentives, the point is very clear: if you give people bad incentives, they behave badly and they behaved just as one would have excepted" (Stiglitz, p. 326). At the organizational level, American's system of corporate governance itself is badly flowed.

With globalization the issue of regulation global economic and financial system is more and more important. Economic and financial crises carry enormous costs in terms of output loss and employment, as evidenced by the recent systemic crisis. Therefore, a fundamental aspect of international monetary cooperation is to step up efforts directed at crisis prevention. For many years, the IMF has been aware of the value of crisis prevention and has tried to improve its surveillance over countries' economic policies to this end. Unfortunately, the historical record shows that surveillance has not been very effective in deterring the build-up of large imbalances. The recent crises prompted important improvements in the surveillance process by strengthening surveillance, particularly in the financial sector, through the Financial Sector Assessment Program (FSAP), the Global Financial Stability Report (GFSR), and theEarly Warning Exercises (EWEs), which are valuable instruments for timely identification of trends and policies that may lead to a crisis down the road. Additionally, the G20 MAP is being developed with the aim of identifying the spillover effects of countries' domestic policies. It should be instrumental in exerting greater peer pressure for the detection and correction of imbalances at their initial stages as a means of preventing imbalances from evolving into major disequilibrium in the world economy. Surveillance, if effective, is the ideal crisis prevention tool. However, the lessons of experience suggest that its effectiveness depends on the will of the largest economies to determine their domestic policies by taking into account their impact on the rest of the world. This is an evolutionary process that has to be supplemented with other tools of crisis prevention. In this context, and considering that the world economy will never be exempt from crisis, the fortification of the IMF's crisis prevention toolkit through creation of the Flexible Credit Line (FCL) and Precautionary Credit Line (PCL) represents an important boost to the architecture of the international money.

---

[1] Stiglitz analysed in details the incentive metters in the article " Lesson From The Global Financial Crisis."

8. Lesson for transition countries

Technically, in United Nations (UN) parlance, the economies in transition (EiT) covers the economies in south-east Europe which are not in the EU (SEE-6), and the CIS. We consider SEE-6 as transition countries. The great problem of transition economics is that they were hitted by the recent economic crisis but also with transition crisis. Over the last 20 years the transition economies have experienced a difficult time. There have now been three major crises and a few more minor and country- specific ones in-between. The recent crisis is severe. However, compared to the transition crisis the recent crisis seems almost insignificant.

Naturally, given the tremendous diversity in the region, countries in emerging Europe have experienced the crisis very differently—ranging from Poland which virtually escaped recession altogether, to Ukraine, the Baltics, Romania and Hungary—all of which suffered severe downturns. What has made the difference in terms of a country's response to the crisis has been the quality of its economic policies and institutions.

In this regard, Poland stands out. Thanks to strong economic institutions and commendable policy management, Poland has avoided the excesses seen in many other countries in recent years. And because there was sufficient fiscal space to adopt temporary stimulus measures, the impact of the crisis on growth was lessened. Indeed, as the largest economy in the region, Poland is leading the economic recovery.

Overall, then, the lesson for transition courtiers is clear: good policies and strong institutions matter. In the process of implementing policies and institution transition countries must adjust national regulation with global solutions.

I'd also like to highlight another key feature of this crisis: namely the courage of many of emerging Europe's leaders to take tough policy decisions. They did not shy away from taking deeply unpopular measures that they knew were necessary to save their economies.

9. Conclusion

The world is one. Where we are? We don't have global rules of law, we haven't global demand, we have debts, we have high unemployment. Debts have been increasing! All economies are concerned. The recent crisis is having consequences around the world. Nobody stays untouched. The world has been faced with specific changes, and doesn't have capability to manage them.

The core of the problem is that we are in the global world, and global market. Rules of law are still local! Global omarket and local rules of law explaining everything. Without rules of law global economy doesn't function. Without it we have anarchy, and corruptions on the global level. The road is reinforcement rules of law, first of all, at the global level, which will allow functioning of the market.

Global institutional infrastructure is out of date. Despite of exceptions, overall IMF success can be perceived as very limited. It can be argued that although the Fund still satisfies its role of a money lender, it has failed its role with relation to predicting an consequently preventing the economic crisis.

At the global level, the world doesn't have enough demand. In absence of global demand, debts have been increasing as surrogate of the demand (private as well as public debts). Salaries have been declining, and debts arise as surrogate of income. In one moment, in the absence of real income, debts blow up till a point.

In analyzing causes of the recent economic crisis, one fact is unavoidable: it is redistribution of the world income. The world income has been concentrated in hand of small number of people. The best illustration of this is USA, where over 80% of income goes to 1% of population.
Unfortunately, global world system doesn't have institutional framework to manage accelerated and specific changes. G-20 hasn't bring up solutions, only move chairs on the Titanic.

The message of the author is development democracy, not only inside states, but also on the global level. The fundamental precondition for that is development and implementation rules

of law on the local as well as on the global level. The author is optimist, in spite of a serious political obstacles, first of all, rivality between USA, and Asia.

References

Appelbaum, B., Cho, D. (2010), "Obama's 'Volcker Rule' Shifts Power Away from Geithner." The Washington Post. 22 January 2010 <http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/ AR2010012104935.html>

Boyd, J. H., Giani, N., Loukoianova, E. (2010), "Banking Crises and Crisis Dating: Theory and Evidence." IMF Working Papers. 10 Jul 2009.

Demirguç-Kunt, A., Detragiache, E. (1997), "The Determinants of Banking Crises in Developing and Developed Countries." IMF Staff papers 45. Washington, DC.

Friedman, T. (2005), The World is Flat: a Brief History of The Twenty First Country, New York: Basic book

Group of 30 (2009), "Financial Reform – A Framework for Financial Stability," 15 January 2009

Herszenhorn, D. M. (2010), "Bill Passed in Senate Broadly Expands Oversight of Wall Street." The New York Times. 20 May 2010. http://www.nytimes.com/2010/05/21/business/21regulate.html?_r=1

Iacono, T. (2008), "Economic Report Summary: Plunging Home Prices and Consumer Confidence" Seeking Alpha. 29 June 2008. http://seekingalpha.com/article/83073-economic-report-summary-plunging-home-prices-and-consumer-confidence

Krugman, P. (2011), The Return Of Depression Economics and The Crisis 2008, Penguin Books

Shachmurove., Y. (2011), The Next Fiancial Crisis" Penn Institute for Economic Research Department of Economics University of Pennsylvania"

Smich, M., D. (2008), The world is curve – Hidden Dangers To The Global World, Penguin Group, USA.

Stiglitz, J. (2010), Lesson From The Global Financial Crisis of 2008, Seoul Journal of Economics 2010, Vol 23, No. 3)

Stiglitz, J. (2011), Free Fall – America, Free Market, And the Sinking of the World Econmy, Norton & Company, New York.