eFinanse
finansowy kwartalnik internetowy

GLOBALIZATION AND EVOLVING NATURE OF FINANCIAL CRISES[1]

Brian Cognato[2], Bartlomiej Kaminski[3]

https://dx.doi.org/10.65748/fiqf-2009-0010

Introduction

The shift from an unprecedented period of remarkably high growth rates across almost all countries in 2001-07 to the first harmonized bust since the Great Depression of the 1930s took most observers by surprise. Popular commentary during the boom years stressed a "decoupling" of the world economy from the US, suggesting that the engine of global growth had moved to the "BRIC" (Brazil, Russia, India, and China) countries and East Asia. The crisis that began in the US in late 2007 has quietly put to rest this notion. The 21st Century boom also contributed to the development of a conviction among policy makers and some economists that we had both the expertise and tools necessary to prevent even mild economic downturns. The current crisis has proved this wrong as well: capitalism is not yet immune to the boom-bust pattern. Indeed, financial markets, the inner engine of capitalist development, are inherently prone to crises. Three forces operating in financial markets amplify the instabilities that make controlling this process difficult. First, the rewards of taking risks under conditions of uncertainty create incentives for herd behavior, amplified by informational asymmetries. Actors mimic other actors assuming that the latter know what they are doing. For instance, banks with no international expertise lend to customers abroad simply because banks heavily involved in international transactions do so. Herds move in groups: they do so when entering markets and when withdrawing from them, exacerbating fluctuations in both directions. Second, financial institutions act on behalf of depositors. This distorts incentive structures so that money managers reap huge rewards when markets go up and depositors take the hits when they go down. This moral hazard encourages excessive risks that may be further exacerbated by the conviction of large lenders that failure would have systemic implications that a government would prevent at any price. Third, financial institutions continually create new financial vehicles designed to spread risks further and expand their capacities to provide credit. Taken together, these bubble-forming pressures are formidable, and, without regulation will drive economic activity to extremes. But not every bubble sparks a crisis, and only few have spilled over abroad. Spillovers may occur indirectly via trade, when a crisis forces a country to reduce imports and triggers new difficulties in exporters, or directly through financial linkages, the intensity and character of which determine their overall impact and may shape events beyond their immediate reach.

[1] The authors wish to thank Roberto de Beaufort from the World Bank for his excellent comments on successive versions of this paper. The usual caveat applies.

[2] Brian Cognato, B.A., was Undergraduate Teaching Assistant to Professor Kaminski during Spring Semester in 2009 and is Development Associate at the international nonprofit organization PeacePlayers International.

[3] Professor Bartlomiej Kaminski (Ph.D. and Advanced Doctoral Degree in Economics from the University of Warsaw) teaches international political economy at the University of Maryland, College Park.

Historically, the Third World Debt Crisis and East Asian Financial Crisis are examples of prior crises that have spilled across borders. On the surface, these events may not appear to have much in common with each other, or the current crisis, except for the well-known mechanisms that create bubbles in asset markets, which are always the same. However, other aspects of these crises shed light on the evolution of economic interdependence and the nature of international crises and the role played by governments in both emergence of financial bubbles and the failure to contain them. The Third World crisis revealed highly developed countries' stake in avoiding defaults on sovereign debt by developing countries and paved the way for the removal of barriers to ties among private economic actors across borders. The East Asian crisis demonstrated the danger of horizontal cross-border links among financial institutions, a defining feature of globalization, and how the absence of regulatory structures allowed financial bubbles to get far too big. The current crisis not only shows a reversal in the normal roles of developing and developed countries, originating as it did in the US banking sector, but also illustrates the cost of irresponsible economic policies in a globalized world.

The remainder of the paper is organized as follows: Section 1 discusses the Third World debt crisis, showing that government policies in both creditor and debtor countries pursued in the changing macroeconomic context provided fuel for the formation of a bubble. Section 2 looks at the East Asian financial crisis and the speed of turnaround despite huge economic welfare losses. Section 3 examines developments leading to the current crisis and provides empirical evidence that the current crisis is "made in the U.S." and has nothing to do with legendary greed or, to paraphrase Ackerlof and Schiller (2009), animal spirits. Section 4 concludes.

Third World debt crisis: government failures across the developmental divide?

Even though the context and major actors involved in the Third World Debt Crisis of the 1980s are well known, the developments leading to it are worth re-examining: the crisis both serves as a key inflection point in the evolution of global markets – the end of sovereign debt crises – and illustrates the role of governments in sparking financial bubbles. On the supply side, loose monetary policies in the developed world expanded liquidity in the banking sector. Combined with the development of new financial "technologies" underpinning the global supply of banking services, this substantially increased the capacity of bank lending. On the demand side, the changes in the distribution of current surpluses and deficits around the world triggered by the first oil shock in 1974 and amplified by the second oil shock of 1979 prompted many developing countries to tap private financial markets for current deficit financing. When the highly developed countries of the global North vigorously implemented inflation-combating reforms to stem recession in the early 1980s, exports from developing countries fell and the cost of financing their debt exploded.

The economic landscape preceding the crisis in the 1970s was marked by "stagflation" in highly developed countries, volatility in foreign exchange rates following the collapse of the Bretton Woods monetary regime in 1971, and the two oil shocks of 1974 and 1979. The oil shocks are of particular relevance because of their impact on (a) the geography of current account surpluses and deficits and (b) macroeconomic policies in highly industrialized economies. The ingredients of inflation existed in industrialized countries before the first shock, but a sudden increase in their oil bills exacerbated inflationary pressures. Their synchronized anti-inflationary measures

coincided with the second oil shock, dramatically changing the external environment for developing countries.

Very high real interest rates replaced the historically low interest rates prevalent during most of the 1970s.Throughout most of the decade, governments of highly developed countries failed to address domestic economic imbalances. Macroeconomic policies reduced their savings and investment rates, and real interest rates stayed persistently low, hovering around one percent in 1970-73 and reaching negative values in 1974-76. Moreover, high inflation rates in the U.S. exacerbated by the surge in commodity prices in world markets led to the depreciation of the dollar: a depreciating dollar made borrowing even more attractive. The environment for financial institutions was thus conducive for investment opportunities abroad. But other conditions had to develop for them to find willing borrowers.

The two oil shocks and the increase in commodity prices following the 1974 shock improved the terms of trade of net exporters and changed the distribution of current account surpluses in oil-exporters' favor. The current account deficit of oil-importing countries fell on average from 1.1 percent of GDP in 1973 to around 4 percent in 1974-75, stabilizing at around 2.0—-2.5 percent in 1976-78 before exploding in 1980-81 to around 5 percent of GDP. Except for 1974 and 1979, when they ran low current account deficits, highly developed countries remained a traditional source of surpluses. Meanwhile, net-oil exporting OPEC countries saw their aggregate surplus increase from 21.2 percent of GDP in 1973 to 51.5 percent in 1974, before falling to 15.5 percent in 1978. The second oil shock brought an improvement in their external position with their aggregate current account surplus increasing to 21.2 percent in 1979 and 32.2 percent of GDP in 1980 (WDR 1985).

The combination of inflation and exploding current account surpluses in mainly Middle Eastern oil-exporters dramatically increased liquidity in the world economy. Indeed, the amounts available for financial intermediation from OPEC and industrial country's surpluses increased from around $17 billion in 1973 to $70 billion on average in 1975-80, and fell to a paltry $4.5 billion in 1982. Oil exporters were the major source of dollar liquidity in these years with their aggregate surpluses over 1973-82 of $363 billion, or 95 percent of the total current account surpluses for industrial and OPEC countries for this period (Table 1).

Financing needs of developing countries, as captured by the size of their aggregate current account deficit, varied over time, displaying step-wise increases in response to the oil shocks and the recession in industrial countries in the early 1980s. After the first oil shock, they increased in terms of current dollars almost four times between 1975 and 1978, and subsequently grew another 50 percent by 1980. Total current account deficits of $491 billion over 1973-81 were concentrated in the last four years, coinciding with the second oil shock of 1979-80. The total over 1979-82 was $324 billion, or two-thirds of the total of current account deficits over 1973-82 (Table 1).

Table 1: Current account of selected groups of countries in 1973-82 (in billions of US dollars)

	1973	1974	1975-78 (a)	1979	1980	1981	1982	Total, 1973-82
Industrial countries	10.3	-14.6	12.1	-5.6	-38.8	3.1	1.2	18.6
Middle Eastern oil exporters	6.5	55.9	33.8	61.9	99.6	56.3	3.3	362.8
Developing countries	-9.1	-21.0	-39.5	-51.7	-68.0	-105.1	-99.2	-491.1

Note: (a) averages over 1975-78.
Source: Own *World Development Report 1985: International Capital and Economic Development*. Oxford University Press, New York, 1985, p. 33.

Western banks were particularly well placed to move surpluses from highly developed and OPEC countries to developing economies seeking to finance their current account deficits, as their lending capacities significantly increased for several reasons. First, OPEC countries invested their surpluses in highly developed countries with efficient and deep financial markets: the US and the UK absorbed around 40 percent of the cumulative OPEC surpluses initially, mainly as bank deposits (WDR 1985, p. 89).

Second, banks' lending capacities were considerably reinforced thanks to "Eurocurrency" markets, currency markets operating outside the control of domestic banking authorities. These banks could operate without restrictions such as domestic reserve requirements, which allowed for much higher profit margins. In addition, US domestic regulations perversely encouraged the development of these markets by capping the interest rates that banks could offer to domestic depositors and limiting the expansion of credits to foreign customers via the US Voluntary Foreign Credit Restraint Program of 1965. US banks responded by establishing a growing number of bank branches abroad (offshore banking centers), which became actively involved in Eurocurrency operations. Eurocurrency loans dramatically expanded between 1973 and 1982 from around $200 billion to $2.4 trillion, with about $300 billion in the form of international loans.

Third, financial innovations also made it easier for banks to effect financial intermediation. Three of them played a particularly important role in reducing banks' perception of the risks involved in international lending: a) a cross-default clause for publicly guaranteed debt provided a strong incentive to a borrower country to reschedule rather than default on its loan; b) newly-invented syndicated loans enabled banks to diversify risk and make long-term loans on the basis of short-term deposits; and c) the linking of interest rates to the current LIBOR (London Interbank Offer Rate) shifted the risk of interest rate increases to borrowers.

Thus, following the first oil shock in 1974, conditions became particularly favorable for both governments and private actors to tap private international financial markets. The absence of capital account convertibility in most developing countries and an adherence to state-led import substitution strategies, combined with a strong reluctance to allow for foreign investment inflows, turned governments into borrowers. Most had a clean credit record, as they had had no access to private financial markets since a series of sovereign defaults during the Great Depression of the 1930s. Many of them also saw their terms of trade significantly improve thanks to growing commodities prices. These developments, as Watkins notes (1986, p. 20), "… transformed many developing countries from paupers into excellent investment prospects and credit risks."

Faced with current account deficits, the governments sought to finance them through private borrowing in order to avoid cuts in domestic consumption. Not all of them had access to private markets, however. International lending was highly concentrated. Most went to middle-income developing countries with records of robust economic growth. Sovereign debt was growing, but not at rates that worried lenders shielded behind new financial instruments, although as the

decade progressed the proportion of loans with floating interest rates rose and the maturity of offered loans shortened indicating the perception of growing risk of lending.[4]

The skyrocketing prices of oil in 1979-80 and the drastic change in macroeconomic policies in highly developed countries, which—after a decade of benign neglect decided to begin fighting inflation—pushed the bubble to the edge of bursting. Foreign exchange earnings of developing countries suffered on two counts: exports earnings stagnated or fell due to decreased demand in developed countries, and the cost of debt servicing increased dramatically, pushed by much higher real interest rates. This produced a spiral of new loans with falling maturing and growing spreads over LIBOR. The bubble burst once banks refused to provide further financing to the government of Mexico in August 1982, setting into motion the herd's withdrawal from new lending to other countries as well. Several other countries, including, among others, Argentina, Brazil, Venezuela, Chile, Nigeria, Poland, Hungary, the Philippines, and Romania faced imminent crisis (Pool and Stevens, 1987, p. 63).

But this was mainly the result of developments in the world economy in the late 1970s. Consider that Argentina was running current account surpluses until 1978, but subsequently its aggregate current account deficits in 1979-82 reached almost $16 billion (Table 2). Mexico's current account deficit more than tripled from $5 billion in 1979 to $16 billion in 1981, and Brazil's deficit increased from $7 billion in 1977 to $16 billion in 1982.

Policies pursued by many of the indebted countries had made their contribution as well. The capital flight that aggravated the external position of the three largest Latin American economies—Argentina, Brazil, and Mexico, which together accounted together for more than one fifth of the total debt of developing countries —provides a very powerful illustration of their failed government policies. Capital flight can be regarded as a vote of either confidence (when the outflows are low) or no confidence (when the outflows are high) to government's macroeconomic and foreign exchange policies: capital flees from unfriendly business environments and hostile investment climates. The scope of capital flight was significant in the Third World Debt Crisis. In its absence, Argentina would have had practically no debt. Mexico's debt would have been 79 percent lower, and Brazil's 17 percent lower (Table 2).

Table 2: Salient features behind debt of three Latin American countries in 1982-83 (in billions of US dollars and percent)

	Aggregate current account, 1976-82	External debt in 1983	Capital flight 1976-82	Ratio of capital flight to external debt	Debt if no capital flight	Share in outstanding debt of developing countries
Argentina (a)	-16	25	27	110%	-2	4%
Brazil	-70	58	10	17%	48	9%
Mexico (b)	-38	67	53	79%	14	10%
Total	-124	149	90	60%	59	23%

[4] Floating interest rates as a percentage of public debt increased on average for major borrower from 18.4 percent in 1974 to 39 percent in 1979, 45 percent in 1981, 46.7 percent in 1982, and 51.2 percent in 1983 (WDR 1985).

above		

Note: (a) Since Argentina ran current account surpluses until 1978, we included only current account deficits in 1979- 82; (b) no current account data available for the period prior to 1979 for Mexico in the WDI database

Source: Own calculations based on data from Pool and Stevens (1987, p. 56), Watkins (1986, p. 8), WDR 1986, and World Bank's WDI database.

One can conclude that government failures in both creditor and debtor countries were responsible for this crisis. Clearly, banks lent money: one should not blame the messenger for a bad news.[5] Government actions created opportunities and incentives: banks simply responded to them. Creditor countries took rather a relaxed approach to macroeconomic stability seeking to absorb rising commodities prices through inflationary measures. They clearly paid a price as anti-inflation resulted in recession in the early 1980s. But so did debtor countries, as skyrocketing real interest rates and falling export earnings raised the cost of debt beyond their financial possibilities. However, instead of encouraging private investments in their economies, the governments borrowed to finance both consumption and investments. Furthermore, they often pursued policies that encouraged capital flight.

One of the most surprising consequences of the explosion of international private lending to developing countries has been a dramatic increase in interdependence between debtors and main creditor countries. The governments of creditor countries could not ignore the financial fate of highly indebted countries. They could not let them default on their sovereign debt as they did during the Great Depression, because defaults of the largest debtors would actually bring down the national financial systems of creditor countries. Banks were too exposed to foreign debt and too big for creditor governments to allow them to collapse. Debtor countries were too indebted, and the risks of a collapse of the banking sector in creditor countries too high to let them default. The shared destiny of banks and sovereign debtors became the major, albeit not the only, consideration shaping the decisions of creditor governments.

A very quick response by the US government to Mexico's plea for financial rescue in August 1982 resulted from, among other factors, the level of exposure of US banks to Latin American countries. US banks lent around $130 billion to developing countries of which more than two thirds or $86 billion were loans to Latin America (Watkins 1986, p. 6). These were huge amounts: consider that $130 million amounted in terms of the US GDP in 1982 to four percent, and the cost of massive default would go well beyond four percent of GDP because of multiplier effects.

Had even a single country out of the four major Latin American debtors (Argentina, Brazil, Mexico, and Venezuela) defaulted, then some major US banks would have to be declared insolvent by the supervisory authorities as the amounts of loan defaults would exceed capital. The default of four major debtors would have led to the closure of six out of eight major banks listed in Table 3, as their Latin American loan to capital ratios exceeded 100 percent (Table 3). These banks accounted for almost two thirds of loans to Latin America. More importantly, these were among the largest banks in the U.S.

[5] Note that the banks did not lend to poor developing countries with little prospects for sustained economic growth in the future. In their portfolio, there were no equivalents of NINJAs (no income, no job, no assets) so amply present in toxic assets responsible for the current crisis.

Table 3: Exposure of major US banks to Argentina, Brazil, Mexico, and Venezuela on December 31, 1984 (in billions of dollars and percent)

	Total exposure to four LA economies (a)	Total primary capital	Ratio of exposure to primary capital
Bank of America	7.4	6.9	107%
Citicorp	10.3	8.9	116%
Chemical	4.0	3.3	122%
Chase	6.7	5.6	120%
J.P. Morgan & Co.	4.4	4.5	97%
Manufacturers Hanover	6.7	4.4	153%
Bankers Trust	2.8	2.8	99%
First Chicago	2.3	2.3	100%
Total	44.7	38.7	115%

Source: Derived from the data in *A Review of Bank Performance*, Salomon Brothers Inc. New York, 1985, as quoted in Watkins (1986, p. 8).

Since debtor countries also wanted to avoid defaults, as these would impose huge long term costs on their economies and jeopardized access to even commercial financing for a long time, there was a confluence of interests amongst borrowers and debtors. The debt crisis management regime that emerged thereafter was based on a case-by-case approach involving a debtor country, banks, and the International Monetary Fund. The latter had a pivotal role in keeping private banks engaged by ensuring the implementation of policy measures by debtor governments that would, among other things, increase a country's capacity to service its sovereign debt.

Both debtors and creditors have drawn important lessons from the crisis. Many debtor countries overhauled their economic regimes and moved decisively towards more open economic system. They have dismantled a host of economic barriers: trade protection significantly declined and foreign direct investment was not only allowed but actively encouraged, thus setting the groundwork for globalization based on the interdependence of private economic actors across national borders extending beyond highly developed countries. Although governments would have to play a crucial role in their resolution, future financial crises would not be only about sovereign debt but about the private sector.

Financial regulators in creditor countries also learned a lesson. New regulations required geographical diversification of banks' lending, and loan reserve requirements increased. Interestingly, the requirement of diversification fueled the development of secondary markets for sovereign debt, which was subsequently used successfully in the Brady Plan of 1989 to retire the Third World debts of the 1970s.

In all, the learning process triggered by the Third World Debt Crisis has brought about important changes. Some devices that encouraged the bubble's expansion in developing countries were removed: new regulations would make impossible the repetition of financial excesses

experienced in the 1970s. Also, many debtor governments saw the Third World Debt Crisis as the result of inward-oriented economic development. They took note that other highly indebted developing countries that pursued export led growth strategies successfully weathered the downturn in the world economy in 1980-83. The result was the emulation of this strategy by a growing number of developing countries, albeit often in a new form.

But the state's withdrawal from sovereign debt by removing some economic barriers preventing direct investment across borders did not eliminate the proclivity of financial markets to produce instabilities and crises. Despite similar dynamics, the macroeconomic context and outcomes of the next crisis would be different. The East Asian Financial Crisis was the embodiment of this new stage of horizontal institutional links underpinning globalization extending beyond the developmental divide.

East Asian financial meltdown and capital account liberalization

By the early-1990s, privatization and liberalization had coalesced into a consensus approach to development typified by the ten *de rigueur* "rules" termed "The Washington Consensus" by John Williamson in 1989. Although subsequently portrayed as 'directives,' they were the summary of policy actions that Latin American policy makers found useful for reviving their economies. Combined with the fall of the Soviet Union in 1991 and the determination of many newly liberated countries to integrate into global markets, this consensus laid the groundwork for the integration of financial markets on a scale unprecedented since World War I ended the First Wave of Globalization that began in the 1860s. This set into motion forces of integration that we now know as the Second Wave of Globalization. The countries of East Asia had adopted outward-looking export-led growth strategies in the early 1960s, but they would not accept financial globalization – particularly capital account liberalization– until after the beginning of this Second Wave. That policy innovation, combined with herd behavior on a massive scale and moral hazard in the financial sector resulting from governmental failure, would produce the next crisis, known also as the East Asian Financial Meltdown.

The countries that that would be most affected by the East Asian Crisis of 1997-1998 (Indonesia, the Republic of Korea, Malaysia, the Philippines, and Thailand) shared four key characteristics prior to their collapse. First, all tied their currency to the US dollar, despite increasing economic links with Japan and the rest of East Asia. These pegs, and the foreign exchange spending that would be required to maintain them, would come to form a crucial trigger in the crisis that followed. Second, their economies were commonly classified under the general heading of "crony capitalism," practiced differently in each country but generally characterized by loose regulations and informal, traditional links between business and government. Third, all posted regular, mounting current account deficits, building an aggregate deficit of nearly $54 billion by the end of 1996, a weakness both mitigated by and caused by their fourth common characteristic, strong fundamentals and a history of recent growth. Indeed, as late as May 1996, the IMF predicted that East Asia would remain "particularly buoyant". The very strength of their track record, when combined with capital account liberalization, produced the investment bubble belied by these current account deficits.

The crisis that began in Asia in 1997 differed from the World Debt Crisis of the 1980s in several important respects: the Latin American Crisis was about macroeconomic fundamentals, the afflicted countries in East Asia demonstrated remarkably strong fundamentals; the Latin American Crisis was about states behaving badly, whereas the Asian Crisis was primarily driven

by private actors, though, as we shall see, government failure played an important role. Most importantly, the Asian Crisis emerged in the new globalized financial system created after the end of the Cold War, one structured in many ways to respond to the state failures that prompted the crisis in Latin America, but also containing new seeds of instability deriving from the spread of capital account liberalization to countries with shallow domestic financial markets. Asia was globalization's first great test. How would the deepening links of an interconnected world affect financial markets' natural tendency to create bubbles, and how would governments perform in their role as bubble regulators?

Commentators such as Joseph Stiglitz (2003: 89-123) have contended that hasty globalization, as embodied by ill-timed capital account liberalization, "… was probably the single most important cause of the crisis." Other analyses have focused on multiple equilibria situations and panic effects (Sachs and Radelet, 2000) or moral hazard (Krugman, 1998). All played a role, but capital account liberalization helped nudge the Asian economies towards crisis in two important ways. First, it greatly increased the sheer magnitude of international financial activity in the countries that would be hit hardest by the crisis (Thailand, South Korea, Indonesia, Malaysia and the Philippines). Capital inflows spiked rapidly as a result of the liberalization measures adopted by East Asian countries throughout the 1990s, themselves the result of the global consensus on integration based on free markets that emerged at the end of the Cold War. According to Sachs and Radelet (1999), net private capital inflows increased from $37.9 billion in 1991 to $97.1 billion in 1996, an increase of more than 150 percent. In and of themselves, of course, greater capital flows are not destructive – in fact, they were likely a key cause of the growth in these economies during the pre-crisis years – but this "herd" was particularly jumpy, overwhelmingly short-term.

Financial liberalization opened the door to cheaper credit as well, but not as might be expected. As governments like Thailand began to peel back interest rate ceilings at the beginning of the decade, increasing the exposure of domestic interest rates to market fluctuations, the spread between the prime-lending rate and 'fixed' deposit rates actually *increased*, probably due to inefficiencies in domestic banking sectors (Nidhiprabha, 2003, 28-30). Still, policy innovations like the creation of the Bangkok International Banking Facilities in 1993 allowed (and even incentivized via tax reductions and exemptions) Thai banks to borrow abroad in foreign currencies, with lower interest rates, for the ostensible goal of encouraging Thai banks to borrow abroad and reinvest that money abroad again. Instead, the banks sought to take advantage of the higher domestic rates, borrowing abroad and investing at home (Nidhiprabha, 2003, 34-35). The BIBF, and analogous developments in other East Asian countries, not only continued to pump investment bubbles by increasing available liquidity and decreasing the effective price of credit; they also allowed domestic actors to build precarious long-term domestic commitments on top of them.

The story regarding information asymmetry and moral hazard is both more straightforward and more controversial. The so-called "crony capitalism" practiced in East Asia before the crisis certainly played a role in its severity. Paul Krugman (1998), in his initial analysis of the crisis in Asia, actually identified the moral hazard of financial intermediaries operating with implicit government guarantees but little to no regulation as the crisis's single greatest cause, although he subsequently revised his views (Krugman, 1999). A lack of transparency as foreign exchange reserves dwindled towards zero furthermore created a perception that economies were perpetually on the brink of collapse, and, when revealed, forced "rescue operations" by actors

like the IMF and U.S. Treasury to be that much more dramatic, when gradual adjustments may have softened the shock and dissuaded speculators. In sharp contrast to the crisis in the Third World in the 1980s, governments themselves were not borrowing recklessly; they, however, were certainly implicit in the reckless borrowing of domestic private actors.

Although in 1995-96, all East Asian crisis countries ran current account deficits except for Malaysia and Thailand, they remained below the level of five percent of GDP, which is usually regarded as a level not threatening external stability (Table 4). Even more surprisingly, current account deficits did not increase significantly in 1997, when the crisis erupted. To the contrary, current account deficits fell except in Malaysia and the Philippines.

However, the U.S. Treasury and the IMF, misreading the crisis as a balance of payments crisis, prioritized correcting afflicted countries' macroeconomic ledgers with the ultimate goal of restoring confidence in their internal markets. Along with significant structural reforms, they prescribed monetary and, to a lesser extent, fiscal tightening (IMF, 2000). Though the "… IMF-supported programs were initially less successful than hoped in restoring confidence in all three countries, with capital outflows and currency depreciations continuing after the programs were introduced," they did lay the groundwork for massive current account reversals – from a combined deficit in the most affected countries of $53.8 billion in 1996 to a combined surplus of $69.8 billion in 1998 (see Table 4).

Table 4: Current account in 1995-98 (in billions of US dollars and percent)

	1995	1996	**1997**	1998	Size of a swing 1998-97
	(in billions of US dollars)				
Indonesia	-6.4	-7.7	**-4.9**	4.1	9.0
Korea, Republic of	-8.7	-23.2	**-8.4**	40.4	48.8
Malaysia	-8.6	-4.5	**-5.9**	9.5	15.5
Philippines	-2.0	-4.0	**-4.4**	1.5	5.9
Thailand	-13.6	-14.7	**-3.0**	14.2	17.3
Total	-39.3	-54.0	**-26.6**	69.8	96.4
	(in percent of GDP)				
Indonesia	-3.2	-3.4	**-2.3**	4.3	6.6
Korea, Republic of	-1.7	-4.2	**-1.6**	11.7	13.3
Malaysia	-9.7	-4.4	**-5.9**	13.2	19.1
Philippines	-2.7	-4.8	**-5.3**	2.4	7.7
Thailand	-8.1	-8.1	**-2.0**	12.7	14.7
Total	-3.7	-4.7	-2.5	10.1	12.6

Note: Annual swing equals absolute difference between values in 1998 and 1997
Source: Own calculations on the basis of data from the World Bank's WDI database.

Indeed, the most important feature of the Asian Crisis has been the speed with which the affected economies have recovered. Already by 1998 the turnaround was dramatic, with all countries moving from deficit to surplus in current accounts—a huge swing amounting to almost $100 billion and 13 percentage points of their aggregate GDP. They quickly accumulated previously depleted international reserves and were able to repay debts incurred during the crisis. Thailand repaid its loans to the IMF in 2003, a year earlier than required under its original deal. Korea repaid its debt in 2001, also ahead of schedule. Even Indonesia, slowed by political upheaval,

repaid the last of its IMF loans in 2006. These quick recoveries certainly owe something to the strong fundamentals of the crisis economies throughout the 1990s – the most appealing aspect of Sachs and Radelet's "panic" account of the crisis (2000) is that it underlines the basic soundness of the crisis-afflicted countries.

Still, recovery did not just consist of sitting back and allowing capital flows to stabilize. After the first great bubble-driven crisis of globalization burst, governments responded not by turning back the clock, but rather by seeking to improve their compatibility with global markets, and with stunning success. First, afflicted countries undertook political and economic modernization. Though the extent to which "crony capitalism" played a role in the crisis is uncertain, and evaluations of the nature of moral hazard in the crisis are on the whole "not decisive" (Desai, 2003, p. 246), the modernization of affected domestic economies is surely a positive development. In Korea, for example, the policy reaction to the crisis was a "comprehensive" set of legislation, ranging from allowing financial regulators to enforce international accounting standards to making the executives of large conglomerates ("*chaebols*") personally responsible for their companies' losses (Desai, 2003, p. 248). In Indonesia, reform took the more dramatic guise of the end of the Suharto regime. Though the scope, speed, and path of reform varied in each country, in all cases it resulted in streamlined economies that allowed domestic markets to quickly regain international trust.

Second, the affected countries committed themselves to a policy of current account surpluses and foreign exchange stockpiling, which, ironically, would turn out to be one of many contributing factors to the current global financial crisis. By 2007, the "Crisis 5" economies posted an aggregate current account surplus of over 67 percent of their combined GDP. Even non-affected countries such as China emulated this move as a hedge against future disaster. Both these responses share an important feature: rather than halting the integration of domestic economies with international markets, they seek instead to manage integration's effects. Only Malaysia implemented capital controls (with not insignificant success, it should be noted). Other economies used the logic of global integration to their benefit, making themselves more crisis-resistant by increasing the size of their own financial arsenal via global trade.

Differences in national responses notwithstanding, their common denominator was not to throw the proverbial baby of globalization out with its sometimes murky bathwater but to devise new ways of tapping economic opportunities by the current wave of globalization.

While both the Third World debt crisis and East Asian crises were caused by monetary excesses that led to a boom and an inevitable bust, the similarities end here. Changes in macroeconomic policies in highly developed countries combined with the second oil shock triggered the Third World debt crisis. Governments were borrowers and Western banks, largely operating outside national authorities' control in Eurocurrency markets, were the lenders. Policies addressing developed countries' earlier failure to control inflation created conditions that put some governments in developing countries on the brink of financial catastrophe in 1982-83 and threatened banking sectors in highly developed countries.

In contrast, the bubble that burst in the East Asian formed as an internal affair between private sectors: financial institutions mostly from highly developed countries lent money to private financial institutions in East Asia. The catalyst of the crisis was not a change in government policies but a sudden, herd-like, withdrawal of funds by Western banks and hedge funds from East Asia. While ultimately the public sector from both creditor and debtor countries had to step in to contain the crisis, the time length and nature of necessary interventions were quite different.

Furthermore, the East Asian crisis was not read as an indictment their strategies of economic development (Bhagwati, 2004, p. 200), whereas the Third World debt crisis was also a death verdict for these countries' inward-oriented development strategies.

The role reversal with a twist

The current crisis erupted not in Latin America or East Asia but in the U.S., both the largest economy in the world and the supplier of its major currency. The trigger was neither the current account deficit nor financial panic. It was the breakdown of the U.S. banking system, brought to the surface in August 2007,[6] with worldwide repercussions and effects spilling over subsequently into the real economy.

While it is a bit premature to provide a definite explanation of its sources and outcomes, three major intertwined narratives emerge: the first relates to the shifting map of current account surpluses and deficits in the world economy and increasing global financial fragility; the second to financial innovations, specifically securitization and derivatives, allowing an almost unlimited creation of credit; and the third to U.S. domestic politics. We shall argue that not out-of-control free markets but U.S. domestic policies contributed to forming the bubble.

The forces that drove global instabilities included the combination of capital account liberalization and exchange rate regimes and the spending and consumption patterns of the U.S. and several other countries in defiance of the "debt cycle" hypothesis. Instead of acting as a mature creditor, the U.S. has displayed characteristics attributable to a young debtor, whereas China, for instance, has behaved like a young creditor, albeit with a twist as its trade surpluses have been growing rather than falling and its current account surplus has risen dramatically.[7] Taken together, they have unleashed unprecedented credit expansion.

None of them alone was sufficient to produce a financial crisis, although they helped create an environment conducive to it. The combination of liberalization of capital account transactions and floating exchange rate regime has the potential to exacerbate instabilities in the presence of interest-rate differentials across countries and increase their vulnerabilities to external financial shock. High interest rates may stem from inflationary pressures and external imbalances as well as from a shallow financial system. Inflows of foreign currency into a country to take advantage of higher interest rate drive up the nominal exchange rate offering foreign investors not only the interest-rate differential but also the currency-appreciation differential. This, in turn, makes a country even more attractive for portfolio foreign investors and provides resources to finance country's current account deficits, allowing consumption to exceed domestic production of goods and services, and delaying an inevitable macroeconomic adjustment. In consequence, countries wind up with even higher imbalances than in the absence of these inflows and, thereby, become more vulnerable to a sudden reversal of these flows. Wade (2008) notes that, because of exchange rates not moving in a direction that redresses external imbalances, foreign inflows contribute to persistence of external disequilibria and "… high global financial fragility" (p. 41). But this may be sufficient to trigger a crisis in a particular country but not one on a larger scale.[8]

[6] Taylor (2009) observes that first symptoms of the financial crisis surfaced on August 9 and 10, 2007, when Interest rate spreads, such as the difference between three-month and overnight interbank loans, rose dramatically with money-market interest rates jumping to unprecedented levels.

[7] For the original discussion of debt stages, see Kindleberger (1958).

[8] For instance, Hungary, particularly negatively affected by the global financial crisis, was a 'victim' of these inflows distorting earlier adjustment to macroeconomic imbalances.

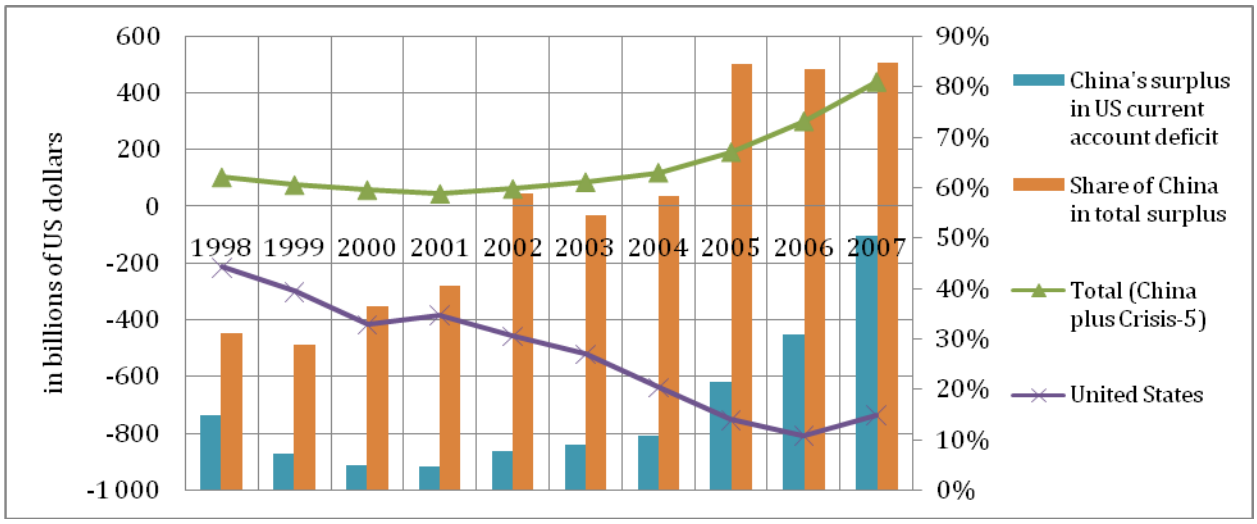
A more potent danger has come from countries running current account surpluses and fixed exchange rates combined in the case of China with capital controls, and the U.S. running increasing current account deficits. In 2004-07, the aggregate current account surplus of developing countries amounted to around $2.4 trillion. China's accumulated surpluses accounted for almost 30 percent of the total. Other large surplus countries were net oil exporters taking advantage of rapidly increasing world prices during this period. Many of them have established sovereign wealth funds with assets valued at around $2.5 trillion in 2008.

Rather than reflecting the limited absorptive capacities of these economies, the development of these current account surpluses in some of these countries, particularly those in East Asia, appears to derive from a conscious policy decision to build international reserves to dampen the volatility of international financial flows. In 1998, they began to assiduously cultivate current account surpluses and stockpile foreign exchange reserves, partially to protect against future speculative attacks and partially to satisfy contingencies attached by the IMF and U.S. Treasury to their rescue packages. They have continued these policies ever since (Figure 1).

Thus, for the countries of East Asia, the buildup of foreign exchange reserves has become accepted as not only a curative, but also a preventative, measure. Except for the Philippines in 1999-2002, other countries were running current account surpluses each year over 1998-2007. By 2007, the "Crisis 5" economies posted an aggregate current account surplus of over $ 400 billion. Non-affected countries like China, with a 2007 current account surplus of more than $370 billion, have followed suit. As an adjustment to (rather than a rejection of) globalization, this approach has proven successful, and the most affected countries have consistently posted GDP growth rates of 5 percent or more.

However, just as the Third World Debt Crisis helped solidify the consensus about the benefits of financial liberalization and privatization that ultimately produced the Asian bubble and bust, so too has this pursuit of large current account surpluses, proceeding apace with further financial innovation and integration, helped precipitate the onset of the current crisis by producing tremendous macroeconomic imbalances. By 2007, the aggregate accumulated current account surpluses of East Asia 'crisis' countries together with China amounted to almost $1.5 trillion (Figure 1). The share of China exploded from an average of 57 percent in 20002-04 to 84 percent in 2005 remaining at this level in 2006-07. The total accumulated surplus during this period of three years was $783 billion.

Figure 1: Current accounts of East 'Crisis' Countries and China against current accounts of the U.S. in 1998-2007 (in billions of US dollars and percent)



Note: Right axis: current account in billions of current US dollars. Left axis: shares in percent
Source: Own calculations on the basis of data from the World Bank's WDI database.

While China and, to a much lesser extent, the five East Asian crisis victims have been suppressing domestic consumption to generate trade surpluses – the major sources of their current account surpluses – the U.S. has been running growing current deficits since the mid-1990s. As a result, two poles have emerged in the world economy: the largest and the most developed economy, the U.S., running current account deficit increasingly with only one country, China, the largest economy in the developing world. China's current account surplus in terms of the U.S. current account deficit moved from 5 percent in 2000-01 to 50 percent in 2007. The five former 'crisis' East Asian countries had surpluses equivalent to 9 percent of the US current account deficit in 2007.

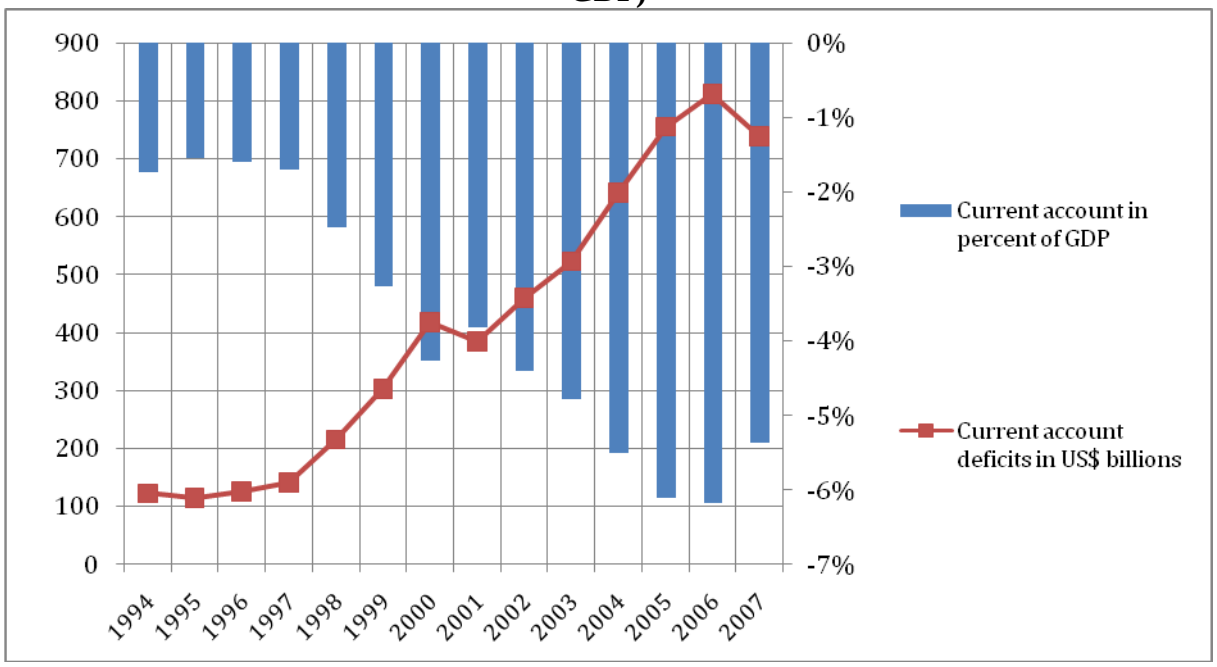
But this kind of world imbalance is not sufficient to produce a financial crisis. In fact, the current pattern is unusual only in one respect: China is a developing country. Otherwise, the 1980s witnessed a similar pattern linking the US and Japan to an even larger extent. Japan's current account surpluses in terms of US deficits were higher than that of China in a peak of 2007. On average in 1982-90, they amounted to 53 percent ranging between 65 percent in 1988 and 35 percent in 1984. Both countries heavily invested their surpluses in US financial markets and other assets. Hence, the puzzle is why the 'Chinese-US imbalance' triggered the crisis and the 'Japanese' one did not. Was there anything special about the current imbalance?

The increased supply of US dollars does not seem to provide an answer. Although the U.S. current account deficits were larger relative to the GDP in the 2000s than in the 1980s, they were not significantly larger relative to international transactions. U.S. current account deficits amounted on average to 2.9 percent of the GDP in 1984-88 as compared with 5.1 percent average in 2001-07. But considering the spectacular, in fact, unprecedented in recent times, rate of the growth of the world economy, one would expect extra amounts of US dollars pumped into the world economy providing much needed liquidity for international transactions.

Similarly puzzling is the time profile of the growth of the US current account deficit, raising doubts again about whether the evolving geography of current account surpluses and deficits provides an explanation to the current global economic crisis. The US current account deficits' time profile is characterized by two expansionary phases (1995-2000 and 2002-06). In terms of

value, the current account deficit almost quadrupled between 1995 and 2000 from $114 billion to $417 billion and only doubled in 2001-06. In terms of the GDP, it averaged 2 percent of GDP in 1994-98, increased to 3 percent in 1999, increased to an average of 4 percent in 2000-02 and 6 percent in 2005-07. Subsequently, it fell back to 5 percent, its level in 2004 (Figure 2). This raises two questions: why did the first expansionary phase that witnessed doubling of the US current account deficit in terms of the GDP fail to produce a financial crisis? Why did a twofold increase in the current account deficits in terms of the GDP and an almost four-fold increase in terms of value not produce a crisis in the 1990s, whereas a 40 percent increase in the current account deficit in terms of the GDP between 2002 and 2006 and a less than two-fold increase in the value of the US current account deficit coincided with the outburst of the financial crisis in 2006?

Figure 2: US current account deficits in 1994-2007 (in billions of dollars and percent of the GDP)



Source: Own calculations on the basis of data from the World Bank's WDI database.

World imbalances do not provide an answer to this question. This analysis suggests that we have to look for the major cause of the current financial crisis beyond the developments in the US current account deficit.[9] The two remaining candidates are a) financial innovations, the

[9] This also implies that Alan Greenspan might be right in suggesting that US current account deficits be put "far down the list" of factors responsible for the current crisis (Greenspan, 2007, p. 347).

securitization and derivatives that allowed an almost unlimited creation of credit, and b) US public policies including monetary policy. Let us turn to financial innovations first. Securitization and derivatives, in particular credit-default-swaps and collateralized debt obligations, appear to have played a major role in the increase of leveraging in the US financial sector. Their proliferation has dramatically expanded access to cheap credit, allowing the smooth financing of ventures that otherwise would never thrive. Securitization has boosted economic interdependence and investment levels by financing high risk business ventures via the distribution of risk among a wide range of investors across borders. This resulting 'democratization' of access to financial markets has been widely regarded as one of the drivers of the current wave of globalization (Friedman, 2000). But they were not the drivers of the current crisis: in fact, they have received too much blame for it.

These changes in the finance structure have dramatically exacerbated the formation of bubbles. These complex financial instruments cut contracts into smaller pieces and combine them with other 'fragmented' loans, and often then are insured against defaults, provided creditors with an (apparently) often false sense of security. Meanwhile, they create complex linkages that are difficult to trace for both regulators and financial actors themselves. In short, these powerful financial tools, based on sophisticated mathematical modeling, appeared able to absorb any uncertainties. This maximization of the complexity of financial products conceals the risks from investors (Wade, 2008, p. 31). The result is that during periods of panic, markets tend to overreact because "… the intricate web of financial connections created by securitization becomes impenetrable" (Smick, 2008, p. 45). It has become extremely difficult to tell a good asset from a bad one, as they have become mixed in the same package,[10] and their combined effect has been a dramatic increase in the potential capacity of the financial sector to create credit at less stringent terms and exposed it to large corrective swings triggered by defaults on relatively small amounts of credit.

Borrowing has become easier not only because new instruments could spread the risks across a growing numbers of investors but also because the traditional relationship between borrowers and creditors in some markets, such as housing, has changed as a result of legislation enacted in 1999 that allowed banks to act as both commercial and investment banks.[11] Banks could now also make money by transforming mortgages into a vast array of complex financial instrument sold them on financial markets. Since the link between borrower and its future financial credibility was broken, banks could offer excessively low interest rates and afford not to be particularly demanding in terms of clients' creditworthiness provided that they could hide it from credit rating agencies.

Thus, the financial structure has emerged with a huge potential for excessive leveraging, i.e., risk taking. But this was only a potential: without fuel, its potential would not be fully exploited.[12] The U.S. government, however, has supplied a 'high quality', if not an explosive, fuel through two venues: the use of incorrect policy instruments to achieve the social objective of affordable

[10] Incidentally, this explains why subprime mortgages, accounting for a tiny portion of financial transactions, could produce chaos in financial markets.

[11] The Gramm-Leach-Bliley Financial Services Modernization Act repealed part of the Depression-Era Glass-Steagall Act, which banned banks from fusing these two separate financial activities. It also allowed banks to consolidate, leading to a concentration of financial services in the U.S.

[12] Note that most of new financial vehicles were developed already in the mid-1990s. For a historical account, see Tett (2009) reviewed by Freeman (2009, A17).

housing for all Americans and wrongheaded monetary policy. Their combination produced the housing bubble that led to the banking crisis subsequently that spilled over to the real economy not only in the U.S. but also worldwide.

The links between the monetary policy and social policy are as follows: low interest rates encourage house purchases, whereas their rise leads to an increase in delinquency and foreclosure rates. Similarly, increases in housing prices lead to increased demand and further increases in prices. As can be seen from data in Table 5, the prices of houses experienced double-digit growth rates in 2000-05 peaking in 2006. Subsequently, the price contracted 21 percentage points in 2007-08. Note, however, that contraction was highly uneven across the U.S. and much higher in low-income areas, exacerbating the crisis (Wray, 2008).

Table 5: Dynamics of prices of housing in 2000-08 (in thousands of US dollars and percent)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
CS Composite-10 Home Price	107	120	133	151	179	209	225	215	179
Change over previous year	13%	12%	11%	13%	18%	17%	7%	-4%	-17%
Index, 2006=100	48	53	59	67	80	93	100	96	80

Source: Calculated from data in Credit Suisse. 2007. "Mortgage Liquidity du Jour: Underestimated No More." *Equity Research*. Homebuilding/ UNDERWEIGHT

Government policies have encouraged ‘mass homeownership’ through exerting direct pressures on banks to provide ‘affordable’ mortgages and shaping the market for home loans through two “government-sponsored enterprises” known as Fannie Mae and Freddie Mac, which purchased loans on the so-called secondary market. Once the original lenders sold their loans to Fannie or Freddie, the companies (or more exactly taxpayers, as we have seen) take over their risks together with monthly payments. This provides the originating bank with the funds to go back into the mortgage market (Woods Jr., 2009, p. 13-15) to serve new customers attracted by the prospect of a quick build up of equity thanks to rising prices. The prices lure new customers, which banks, now able to divest themselves of the mortgages, eagerly seek as well, prompting them to apply not "prime" standards but much lower standards. By the same token, these “subprime” or junk loans were the riskiest category of consumer lending. Subprime lending increased from $138 billion in 2000 to $665 billion in 2006, growing in 2003-04 at annual rates exceeding 30 percent (see Figure 3).

Infusion of politics into banks’ lending decisions has provided strong incentives to both reckless lending and borrowing. The Community Reinvestment Act, re-invigorated by the Clinton administration in the second half of the 1990s, exposed banks to discrimination suits if their lending to minorities would not meet ‘racial quotas.’ In addition, various activist groups organized demonstrations, making business impossible for banks until they expanded lending to

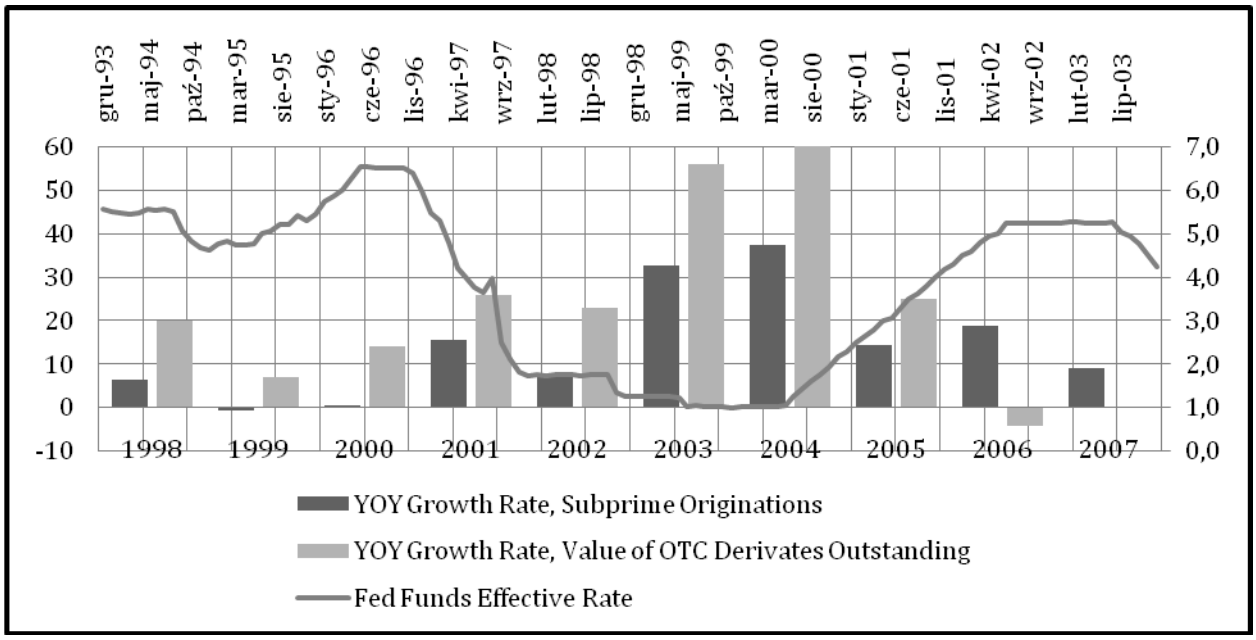
consumers who did not meet reasonable requirements. Banks, aware that they could easily sell these mortgages to government-sponsored entities, obliged and significantly lowered standards and introduced various 'teasers' to attract new customers. As long as housing prices kept growing, and they did until 2006 (see Table 5 above), the delinquency rates and foreclosure rates were falling. They rose significantly in 2007, when the prices began falling.

Monetary policy did not attempt to contain the powerful incentives stemming from the positive feed-back mechanism of financial markets and political pressures that enlisted banks to help with the government-sponsored 'home ownership' program. To the contrary, the Federal Reserve supplied the fuel, which increased the systemic risk bubble and created moral hazard on a gigantic scale (Winiecki 2009). Beginning in 2001, the Fed successively slashed interest rates down to one percent in 2003-04. As the Fed rates were falling in 2001-04, the value of subprime originations was growing: when they increased, the pace of issuing junk loans went down (see Figure 3).

The surge in housing prices, as shown in Table 5, coincided with expansionary monetary policy, which—according to Taylor (2009)—was well below monetary guidelines derived from his well-known (Taylor) formula, which can determine what good policy should be based on historical experience. The Fed has also ignored the booming performance of the U.S. and world economy and the depreciating US dollar in foreign exchange markets.

The two-fold counterargument that (a) the Fed, faced with excess liquidity generated by imbalances in the global financial system, had no other choice and (b) the Fed controls only short-term interest rates and not longer-term home mortgage rates does not stand up to scrutiny. First, Taylor, citing the IMF, points to a decline in global savings and investment as a share of the world GDP since the 1970s. Hence, there was no excess liquidity in the global system: the conclusion also supported by our earlier discussion of US current account deficits. Second, although indeed the Fed sets short term rates, the movement of these rates significantly shapes longer-term rates simply because short-dated commercial paper funds financial actors dealing in mortgage-backed securities.

Figure 3: Federal Reserve Fund's effective rates in January 1998—August 2007 and annual growth rates of OTC (over-the-counter) derivatives and subprime mortgages



Note: **Left axis**: annual growth rates; **Right axis**: the Fed effective rate
Sources: based on data derived from respective websites for Federal Reserve Board, Bank for International Settlements, and Credit Suisse. 2007. "Mortgage Liquidity du Jour: Underestimated No More." *Equity Research*. Homebuilding/ UNDERWEIGHT

Excessive liquidity, created by the Fed's rate policy, found its niche not only in subprime mortgage markets but also in highly speculative financial derivatives. As can be seen from data in Figure 3, expansion in their issuance also appears to be negatively correlated with the Fed funds effective rate: they posted the largest annual increases when the Fed held rates at one percent in 2003-04. The value of outstanding derivatives rose from $10 trillion in 2002 to $25 trillion in 2005, about twice the US GDP. The fact that Fannie Mae and Freddie Mac provided security for many of these contracts takes off some responsibility from the Fed but also shows the scale of the government failure (Shelton 2009).

The current crisis has not been the result of globalization going amok. The US stands largely alone among other world economies as it cannot claim that it has been victimized by developments beyond the control of US authorities, whereas other countries can argue that the infrastructure underpinning globalization has brought to them the crisis. The crisis is not the result of excessive liquidity generated outside the US borders. Neither is it the result of China's current account surpluses. Instead, it can be attributed to excesses of monetary policy combined with government-created incentives that encouraged reckless borrowing and lending to which financial structures dutifully adjusted, displaying impressive innovativeness.

That the US crisis has gone global testifies to the multiple linkages holding together the global economy. Financial bubbles that burst in the US have had worldwide consequences as banks and funds from other countries invested large amounts either directly in US financial markets, regarded as the deepest and most effective in the world, or through institutions exposed to US financial markets. American-generated financial instruments containing toxic assets, usually well hidden with good assets, no longer could be trusted, eroding the confidence critical to bank operations. The reluctance to engage in banking transactions deprived the real economy of credit

not only in the US but also in other countries. With the spillover of the crisis to the real economy, import demand has fallen in the US as well as in other countries.

Concluding observation

The current crisis is different than the previous crises examined here. We have the first truly global crisis, triggered by policies of the global economic hegemon, preceded by the first truly global economic boom of 2001-07. This is a truly remarkable role reversal in comparison to earlier crises where the US was in a position of a rescuer with different motives to intervene. During the Third World Debt Crisis, the US was an unwilling stakeholder during its initial stages. The exposure of the US was so deep that the default of any of a large Latin American would trigger a crisis of the US banking sector: the U.S. and Latin American debtors were in the same boat, albeit for a different reason. The private sector put the U.S. in this situation, whereas the debtors' private sector was not part of the game: governments incurred debt.

The East Asian financial crisis was the result of direct ties amongst domestic and financial actors, which, once crisis erupted, had to be rescued by countries' respective public sectors, though creditor countries' banking sectors were not significantly threatened. The emergence of horizontal ties was made possible by the removal of policy barriers to capital flows representing a significant step towards globalization. By weakening their controls at economic borders and harmonization of these controls with regimes of the developed world, developing countries and countries transitioning from centrally planning set the stage for a truly global second wave of globalization. The East Asian crisis was the first financial crisis of the second wave of globalization: it was not triggered by external disequilibrium, but by financial controls not in line with the liberalization of capital flows. In contrast to the current crisis, it was largely contained to one region, although a few emerging markets were affected by "contagion".

The current crisis represents a higher level of interdependence: the crisis of the US financial sector spread across the globe affecting most countries. The crisis can be blamed almost exclusively on US public and economic policies conducted in complete disregard of their possible global impacts. The authorities allowed for bubbles to form and the US dollar to fall in 2004-07 resulting in inflationary pressures in commodities markets. The crisis has not discriminated, although its impact has depended on the particular policies pursued. But even countries whose governments conducted sound and responsible macroeconomic policies have been victimized by the crisis "made in the USA."

It is impossible to tell whether the crisis will bring about a higher sensitivity to cross-border spillovers of domestic policies in the U.S. The two earlier crises triggered a learning process: in response to the Third World crisis, developing countries moved to outward orientation and active pursuit of integration into global markets for goods, services and capital; the East Asian crisis led to an emphasis on the development of financial regulatory structures and adherence to prudent macroeconomic policies. In the future, will the US take into account the impact of its domestic policies on other countries? Will the current crisis lead to the emergence of global structures that could discipline governments in ways similar to multilateral disciplines negotiated under the umbrella of the WTO agreements? It remains to be seen what answers the future will bring.

References

[1] Ackerlof, George A. and Robert J. Schiller. (2009). *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism*. Princeton University Press, Princeton, N.J.

[2] Bhagwati, Jagdish (2004). *In Defense of Globalization*. Oxford University Press, New York, 2004.

[3] Freeman, James (2009), "The Credit Crisis and Its Creation." The Wall Street Journal, May 13, 2009.

[4] Friedman, Thomas (2000). *The Lexus and Olive Tree*, Anchor Books, New York, 2000.

[5] Desai, Padma. (2003). *Financial Crisis, Contagion, and Containment.* Princeton University Press, Princeton N.J. 2003.

[6] Greenspan, Alan (2007). *The Age of Turbulence*. Penguin Press, New York, 2007.

[7] [IMF 2000] IMF Staff. 2000. "Recovery from the Asian Crisis and the Role of the IMF." *IMF Issue Brief*. June 2000.

[8] IMF Staff. 1996. *World Economic Outlook*, IMF, Washington D.C., May 1996.

[9] Kindleberger, Charles (1958) *Economic Development*, McGraw-Hill, New York, 1958

[10] Krugman, Paul. 1998. "What Happened to Asia?" Unpublished conference paper. Japan. Available at http://web.mit.edu/krugman/www/DISINTER.html.

[11] Krugman, Paul. 1999. "The Return of Depression Economics." *Foreign Affairs* 78-1 (January/February 1999), pp. 56-74.

[12] Nidhiprabha, Bhanupong (2003). "Premature liberalization and economic crisis in Thailand." *Financial Liberalization and the Economic Crisis in Asia*. Chung H. Lee, editor. Routledge Curzon. New York, NY, 2003

[13] Radelet, Steven and Jeffrey Sachs (2000). "The Onset of the East Asian Financial Crisis," in Paul Krugman, ed., *Currency Crises*. University of Chicago Press. Chicago, IL. Pgs. 105-158.

[14] Radelet, Steven and Jeffrey Sachs (1999). "What Have We Learned, So Far, From the Asian Financial Crisis?" Harvard Institute for International Development, CAER Discussion Paper No. 37, 1997, presented at the Annual Meetings of the American Economic Association (January). Available at www.cid.harvard.edu/archive/hiid/papers/aea122.pdf.

[15] Smick, David M. (2008). *The World is Curved. Hidden Dangers to the Global Economy*. Portfolio, The Penguin Group, New York, 2008.

[16] Shelton, Judy (2009). "Loose Money and the Derivative Bubble." *The Wall Street Journal*, March 27, 2009.

[17] Stiglitz, Joseph. 2003. *Globalization and Its Discontents*. W.W. Norton & Company. New York, NY. Pgs. 89-132.

[18] Taylor, John (2009), *Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis*, Hoover Press, Stanford, CA., 2009.

[19] Tett, Gillian (2009), *Fool's Gold*. Free Press, New York, 2009.

[20] Wade, Robert (2008). "The First-World Debt Crisis of 2007-2010 in Global Perspective." *Challenge*/July-August, 2008.

[21] Watkins, Alfred J. 1986. Till Debt Do Us Part. Who wins, who loses, and who pays for the international debt crisis. University Press of America, Washington DC.

[22] Woods Jr., Timothy E. 2009. *Meltdown: A Free-Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse*, Regnery Publishing, Inc. Washington DC.

[23] [WDR 1985] *World Development Report 1985: International Capital and Economic Development*. Oxford University Press, New York, 1985.

[24] Winiecki, Jan (2009) "United States and Global Financial Crisis," *mimeo,* Tischner School of European Studies, Cracow, March 2009.

[25] Wray, Randall L. "Lessons from the Subprime Meltdown." *Challenge*/March-April 2008. Pgs. 40-68.