The quip from books on military history is that the generals plan to fight the next war as if it were going to be similar to the last war. The counterpart statement for those who develop regulatory initiatives to forestall banking crises is that they still do not understand that the cause of the debacles in the United States, Great Britain, Iceland, Ireland, and Spain in the autumn of 2008 and why Greece and Portugal had sovereign debt crises fifteen months later. That these countries had crises at about the same time suggests that each was a national manifestation of a global event, more or less the financial counterpart of an epidemic like the Spanish flu or the Ebola virus. Each of these countries had a boom in the several years before its crisis. Not every country that had a boom had a subsequent crisis, but even country that had a crisis previously had a boom. Moreover each of these countries had experienced an increase in its capital account surplus, which was the mirror of the surge in the demand for international reserve assets by China and the oil exporting countries including Saudi Arabia, Norway, and the United Arab Emirates, these countries could develop current account surpluses only if the United States and the other industrial countries developed the counterpart current account deficits. It was as if there was a tango between one group of countries with the trade surpluses and the capital account deficits, and a second group of countries with the capital account surpluses and the trade deficits. If China and the oil exporting countries had used all of the increase in their export earnings to buy more imports, the United States and the other oil importing countries would not have experienced sharp increases in the prices of real estate and stocks. These increases were the direct result of the increases in their capital account surpluses. The rapid increase in the supply of credit available for mortgage loans in the United States and other industrial countries led some lenders to lend money to borrowers that previously would not have qualified for credit.

The variability in cross border investment inflows is larger when currencies are floating than when they are attached to parities because the increase in inflows leads to higher prices for both currencies and securities that encourage even larger inflows. Some investors have decided to refrain from buying more foreign securities because they asked “Where will the borrowers obtain the money to pay us the interest if we stop providing them with the money in the form of new loans?” But the episodic crises indicate that the many investors have not asked the question, which represents a form of market failure. The fallacy of composition is relevant; individual investors may believe that they can reverse their positions before prices begin to decline even though investors as a group cannot.

The trigger for the global crisis was the slowdown in the increase in U.S. property prices, which meant that some borrowers that previously had relied on money from new loans for the interest payments on the outstanding loans needed an alternative source of credit. Some of these borrowers became distress sellers of real estate, many defaulted on their loans. Property prices then declined. The sovereign debt crisis developed in Greece when the stringency in the global credit market meant that its government could no longer rely on the money from new loans for the interest payments on its outstanding indebtedness; the government then would default if it could not increase tax revenues or cut government expenditures. The threat of default led the European Central Bank and the International Monetary Fund to lend to the Government of Greece, which enabled the it to avoid the default.

The cause of the global crisis was the sharp increase in the supply of credit available to borrowers in the United States and other industrial countries as a result of the increase in their capital account surpluses; if these surpluses had not increased, asset prices in these countries would have increased far less
rapidly. The necessary condition for the crisis was that the increase in the external indebtedness was too rapid to be sustained; the sufficient condition was that the indebtedness of some of the borrowers was high relative to their incomes. When these borrowers could no longer rely on money from new loans for the interest payments on the outstanding loans, many defaulted.

The increase in asset prices in the United States and the other industrial countries was an integral part of the adjustment process to ensure that their current account deficits would increase as their capital account surpluses increased; otherwise the market in each country’s currency would not have cleared. It was highly likely that these prices would decline once the cross border investment inflows slowed. The implicit assumption of the regulatory initiatives is that the cause of the crisis was the surge in bank loans to borrowers with marginal credit histories. The banks were responding to the conditions in the credit markets. These increases in cross border inflows—or in Japan, the reduction in investment outflows—meant that the supply of saving in each country increased, which led to larger purchases of securities and real estate. As the prices of these assets increased, bank profits and bank capital increased which enabled the banks to increase their domestic loans at a more rapid rate.

The increase in the external indebtedness of each of these countries except Japan was larger than the interest payments on its indebtedness, which meant that the borrowers incurred no burden in making their debt service payments, since all the money that was needed for the interest payments was obtained from the lenders in the form of new loans. A similar set of statements can be made about the growth of the domestic indebtedness. The increases in external indebtedness and domestic indebtedness were much more rapid than the increases in GDPs and the borrowers’ incomes, and hence were too rapid to be sustained.

One approach to reduce the likelihood and severity of these periodic banking crises would be to dampen the variability in cross border investment inflows. A complementarity approach would be to manage the changes in the domestic component of the reserves of the banks in each country to dampen or offset the changes in each country’s capital account surplus. Increases in capital requirements and restrictions on the assets that banks can acquire will stimulate the growth of the shadow banks without reducing the likelihood or severity of banking crises. The source of the problem is that the floating currency arrangement is inherently unstable, which leads to the boom and bust cycles in the domestic credit markets.