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## **NOTES FROM THE EDITOR-IN-CHIEF**

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#### **The Global Financial Crisis: Daunting Tasks Ahead**

The global financial and economic crisis started in 2007 as an aftermath of the housing sector bubble coupled with aggressive lending practices in the US sub-prime mortgage market and lax regulation of the financial sector. To start with, these developments affected the companies holding mortgage-backed securities and credit derivatives. The early signs of the crisis were evident in 2007; but the financial crisis developed into a full blown global recession in late 2008 battered by continuous deepening and widening of the crisis. The recession created shockwaves through the global financial system and the global economy, and the advanced economies were affected most. The governments in these countries are bracing their financial sector and the real economy by stepping up various policy measures including injecting huge sums of money for bailing out the ailing financial institutions and other industries. What is worst is that the recession appears to hang on throughout 2014.

The makings of the crisis were essentially in the US imbalances exported to the rest of the

world, over the last couple of decades or so, in the form of persistent current account deficits. The position of US dollar as the dominant global reserve currency enable US to pursue lax macroeconomic policies indefinitely, with its deficits financed externally by economies running surpluses. Not since the beating down of US inflation in the nineteen eighties by US Fed under Paul Volcker at substantial pain of a domestic recession has the US opted again for domestic adjustments to correct imbalances; nor unlike the EU, has the US committed itself unequivocally to pursuing balanced policies (fiscal accounts were in balance in the Clinton era but private sector deficit unrestrained, and in the subsequent Bush era deficits of both public and private sectors ran amok).

In the lax US monetary and fiscal policy regime the surfeit of cheap liquidity surged in several aberrant directions chasing higher returns; into speculation creating commodity and asset price bubbles (the incipient US house price bubble at the turn of the century actually eased the pains from the dot com bubble burst), into equity buybacks with reckless leveraging (improving

return on equity but worsening the fragility of corporate finance), into loans to borrowers of dubious credit and securities backed thereby, into derivatives of inscrutable complexity concealing the riskiness of the underlying assets. Close global integration transmitted these trends of the US financial markets and institutions quickly to the other open economies, including those pursuing balanced policies. Also, the laxities of US monetary policies immediately and automatically surfaced in the economies with currencies pegged to US dollar, including the Middle Eastern oil exporters. The surging wealth from price bubbles in commodities and assets flowed not into combating global poverty, environmental degradation or climate change; but largely into hedonism of private jets, yachts, mansions and other indulgences including such whimsical, fanciful pursuits as competition in mega scale fairytale-like construction projects, artificial islets curved in the Gulf with coastlines alien to known laws of hydrodynamics, mega dollar artworks like golden lamb and Kate Moss gold statue. Now the whole fantasy structure faces collapse as popping price bubbles triggered chains of debt default, paralyzing markets with freeze up of fresh lending to refinance maturing debts.

Small economies like Bangladesh are however by no means invulnerable to fallout from prolonged global downturns or to negative spillovers of policies of large economies, and therefore have strong stake in global stability. In forums like G-20 they need to argue forcefully for the same high priority to stability as to recovery; and also for stability action agenda going beyond addressing symptoms (lapses in risk managements, inadequacies of regulation and supervision) to addressing the

underlying cause (lax policies allowing unbridled liquidity expansion, incubating bubbles).

A safe path of global balance and stability will be a lot easier if global liquidity growth is tied to the growth of real global output in some mechanism that injects and withdraws liquidity counter-cyclically as global real output growth slackens or paces up. The IMF (reformed with appropriately rebalanced voting rights and quotas for member economies) can be mandated to craft and administer the tying mechanism, in a new role somewhat as the apex global monetary agency.

Consensus building for such a new mechanism (in broad likeness of gold standard, with real global output substituting for gold) may be arduous, all the more reason for kicking off the consultation processes at the soonest possible.

Significant gain in global financial stability can be expected also from reforms limiting excessive leverage in corporate finance. In the current crisis the high fragility brought about by reckless substitution of equity with debt precipitated extended chains of debt defaults, paralyzing financial markets across major economies. A corporate generally favors debt over equity because debt servicing costs are tax deductible while income on equity is subject to taxation. However, in downturns, debt burden deepens a firm's financial distress, even inviting demise, as made amply evident by the current global financial crisis.

The Bank for International Settlement (BIS) in Basel, Switzerland for some years is engaged in developing global norms of capital adequacy for banks and financial institutions. BIS can also be mandated to develop global norms of

debt equity balance and sound practices in corporate financing, limiting tendencies of excessive leveraging. To this end, some extent of tax break on income from equity, narrowing

the gap in relative attractiveness of debt and equity as financing option, may also be well worth considering.

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*Dr. Salehuddin Ahmed joined as the Governor of the Bangladesh Bank ( The Central Bank) on 02 May, 2005 and completed his four year tenure on 30 April 2009. Dr. Salehuddin Ahmed was the Managing Director of Palli Karma-Sahayak Foundation (PKSF), the apex funding agency of microcredit operations in Bangladesh. He obtained his Ph.D. in Economics from McMaster University, Canada in 1978. He started his career as a teacher in Economics at Dhaka University and then joined the civil service of the government in the erstwhile Civil Service of Pakistan (CSP) cadre. He served in various capacities in field of administration in the Government of Bangladesh. He worked at the Centre on Integrated Rural Development for Asia and the Pacific (CIRDAP), a regional inter-governmental organizations with its headquarter in Dhaka. He was the Director General of Bangladesh Academy for Rural Development (BARD) Comilla. He also worked as the Director General of the NGO Affairs Bureau under the Office of the Prime Minister. He has authored more than 60 books, reports and journal articles which have been published at home and abroad. He is now a Professor, School of Business, North South University, Dhaka.*