to the United States depressed long-term interest rates. As a result, European and US investors increasingly invested in securitised bonds. This development amplified risks on the asset side of the balance sheet of many financial institutions, undermining the assets’ notional book value.

...created a high liquidity environment where financial risks were often mispriced

The combination of a willingness of intermediaries to accept higher risks with the desire of many households to increase their leverage created the conditions for increased lending and borrowing. With subdued real income growth, cheap credit became a substitute for rising incomes. Securitised bonds and the rise of the shadow banking industry fuelled the capacity of the banking system to expand credit. Safe ratings for securitised bonds created a false sense of security but these ratings were a product of flawed underlying models.

...to be matched by a significant institutional failure in these economies

Regulatory institutions failed to recognise the tensions that were building up in financial markets. Many shadow banking instruments were not covered by regulatory requirements and associated risks were insufficiently understood by regulators. Regulatory capture and the lack of coordination across jurisdictions led to light-touch regulation and inadequate supervision of financial markets.

NEW APPROACHES AND POLICY IMPLICATIONS

The increasingly interconnected nature of the financial sector...

Factors such as the increasing interconnectedness of the financial sector, the complexity of financial products, and the inadequate oversight and regulation of the financial system were central in triggering the crisis. The shock to the world economy fundamentally eroded trust in governments and market institutions and brought into question the validity of analytical tools. Against the backdrop of an uncertain economic environment, rebuilding trust will be the most important yet the most delicate task for policy makers.

...calls for more coordination and cooperation...

Earlier crisis resolution efforts – such as low policy rates – have in all likelihood contributed to the build-up of tensions that preceded the current crisis. Expansionary monetary policy was initiated following the crisis to prevent an excessive reduction of liquidity. In the years since, unprecedented actions have been taken by central banks, especially through quantitative easing programmes. This is uncharted territory as there is no experience on which to consider the likely long-run effects of unconventional monetary policy. In order to prevent adverse economic effects, particularly in emerging markets, when the extraordinary post-crisis measures are brought to an end, an unprecedented level of coordination and cooperation across jurisdictions will be required.

...an urgent need for wide-ranging surveillance and monitoring mechanisms

International capital flows have, in many cases, been clearly misguided into unproductive investments. The urgent need for large scale surveillance and monitoring mechanisms of international imbalances, including of gross financial flows, is an important lesson from the crisis.

A policy regime that focuses on inclusive growth is critical...

Rising inequality was a feature of many economies in the lead up to the crisis. Of course, financial crises can and do occur in more equal societies, but diminishing inequality can help to reduce some of the major macroeconomic tensions that heightened the intensity of the recent crisis. A move towards a policy regime that focuses on inclusive growth is therefore crucial.

Greater policy efforts are required to channel institutional funds to more productive activities,...