Sub-prime Crisis and its Aftermath - A Threat to Global Capitalism?

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Abstract

The recent development in the sub-prime market reveals that the international financial system is passing through a crisis phase no one anticipated. The nature of this crisis and the spillover effect demonstrates that the creation of capital through securitising low-rated risky mortgages, allowing increase in home ownership especially among minority groups who found it hard to have access to home loan, exposed a large population towards economic uncertainty. The new feature of this lending business is that default risks are now dispersed from traditional lending institutions to capital markets. The crisis shows howuviable and risky mortgages and the new popular mortgage-related securities are now dependent on continuing house price appreciation. Considering the potential danger of this development, governments in many countries are making targeted interventions through reserve banks to minimise the challenges the world capitalist system is confronting.

This paper examines some key factors that determined the lending standards practices when fee-remunerated intermediaries in the securitisation process had no incentive to monitor and maintain long-term loan quality. The paper argues that lending standards were relaxed to generate high-yielding loans to meet securitisation demand. It also examines the possible impacts of the sub-prime crisis on developed or developing country share markets. Most of the actual and likely losses from sub-prime delinquencies have been suffered by bankrupt originators, on-balance sheet lenders, or investors in the riskier asset-based securities. Remedies such as greater transparency of lending procedures, accountability of management, tightening of regulatory framework are in today’s financial management carriage. However, at present, it is hard to find long-term sustainable strategies to face the blanket arrest of global economic growth. The sub-prime catastrophe and the rollercoaster ride of global financial markets have shaken the foundations of the capitalist economy, which is more reliant on an alliance structure, replacing the hierarchical structure of the capitalist market. Whether the ricochet effect of the sub-prime crisis will beckon the fall down of the capitalism in coming days is a million dollar question.

Key words: Sub-prime crisis, globalisation, capitalism, economic development, financial institution, securitisation.
Introduction

In today’s global market economy functional capital markets are inevitable because capital is the leading focus of capitalism (Stiglitz, 2006). A fundamental shift is occurring in the world economy in which national economies are not self-contained entities. In a highly globalised economy we are moving toward a world in which barriers to cross-border trade and investment are declining; perceived distance is shrinking due to advances in transportation and telecommunication technology; and national economies are merging into an interdependent, integrated global economic system. Due to the spiral growth of virtual business transactions and the mobility of investable capital across industries and regions, the dependence on banks and various forms of financial institutions for borrowing has increased (Bogle, 2005). Capitalist enterprises such as banks, bonds or stocks can be termed as black boxes (Fig. 1), in which money can be put in one end and more money emerge from the other (Robbins, 2008). The aggressive demand for capital has tilted the global economy towards uncertainly and instability, which at times risks fundamental values (Stiglitz, 2006). The demand for capital led lending institutions to compromise with some fundamental market principles.

Figure 1: The Black Box (adopted from Robbins, 2008:44)

The global capitalist economy can be categorized into four functional types (Baumol, Litan & Schramm, 2007) in the context of ownership and control structure. First, under state-guided capitalism, government guides the market and accumulates and invests capital. Second, under oligarchic capitalism, capital and power are controlled by a small group of individuals and families. Third, under multinational capitalism,
the market is dominated by giant enterprises. Fourth, under entrepreneurial capitalism, the economy is largely guided by small and innovative firms. The shift is from ownership power to a new concept of managerial power that has created many small but powerful international enterprises, many of which operate on-line and have no direct contact with stakeholders (Bogle, 2005; Baumol et al. 2007).

In recent times, the debt market, a key element of capital markets, has not been working smoothly (Stiglitz, 2006). The erratic behaviour has caused social and political problems in many parts of the world. The diverse impact of the debt market crisis demonstrates that capitalism is more than an economic system, because the consequences of its multi-functional dimensions have far-reaching impacts (Robbins, 2008). Factors such as loss of confidence, real estate bubbles, exchange rate management, and lack of transparency might solely or jointly ‘cause’ a crisis (Stiglitz, 1999) for capitalist economy.

Globalisation is an outcome of today’s market capitalism and effective competition and confidence in market principles are necessary for its proper functioning (Stiglitz, 1999). The recent events in the world financial system demonstrate that it is in turmoil. The stock market collapses of 1987, the Asian crisis of 1997-98, the long-term capital management collapse in 1998, and the collapse of the share market and dot.com bubble (Beams, 2008) are not good examples of today’s capitalist economy. Overborrowing and overlending by financial enterprises have led to many of these crises in the last few decades (Stiglitz, 2006). In recent times, the collapse of Lehman Brothers, the US$85 billion rescue of largest insurance company American International Group (AIG), the bailout of investment giants Fannie Mae and Freddie Mac and market uncertainty despite the injection of $700 billion to keep major financial institutions afloat are ominous signs that may lead to tsunami like global economic turmoil (Boyne, 2008).

In capitalist economies middle-class families are the prime targets who are hungry for capital to meet their dreams (Frank, 2007). In targeting this segment of the potential borrowers, banks and financial institutions used bad lending practices and the borrowers taking out mortgages they could not afford (Paulson, 24 September 2008). But the slippery drive of capitalist enterprises created severe casualties in the market,
known as the ‘sub-prime crisis’. Now economists are forecasting a recession as the global financial institutions have considerable weaknesses and the credit crunch has major implications for the sustainability of the global capitalist economy (Beams, 2008). But the consequences of sub-prime crisis and the subsequent failures of financial institutions and the frozen credit markets have threatened all parts of world economy.

By definition, ‘the sub-prime’ is the name given to mortgages extended to individuals who do not qualify for prime credit, i.e., individuals who have a higher likelihood of default (Jonker, 2008:9) and generally not eligible to acquire finance from traditional sources. Sub-prime mortgage market is a sector that has intrinsic relationship with mainstream functional capital market. The aftermath of this crisis has a serious impact. On 24 September 2008, the US President had to address the nation to inform the seriousness of the events unfolding. The US President said ‘We've seen triple-digit swings in the stock market. Major financial institutions have teetered on the edge of collapse, and some have failed. As uncertainty has grown, many banks have restricted lending, credit markets have frozen, and families and businesses have found it harder to borrow money (The New York Times, 24 September 2008). Financial assets related to home mortgages have lost value during the house decline, and the banks holding these assets have restricted credit. As a result, the US economy is in danger.

This paper examines: (a) the related factors that caused deterioration in the lending standards when fee-remunerated intermediaries in the securitisation process had no incentive to monitor and maintain long-term loan quality; (b) and reviews how the structure of the sub-prime market impacted on financial markets and market participants.

The examination of these questions would help to assess the inherent problems of the world financial system and the possible determinants of the credit crunch. It argues that lending standards were relaxed to generate high-yielding loans to meet the securitisation demand that facilitated the crisis. Global leaders are moving forward with several international, regional and economic forums such as the UN, EU, APEC, etc.
towards advancement of global governance. But these forums or associations have limited policy issues in regard to global financial management. It is also argued that united efforts in managing financial market delinquencies need to be addressed appropriately, which might light the way towards global economic sustainability.

Chronicle of the Sub-prime Mortgage Market and Global Economy

The sub-prime crisis emerged in July 2007 when Bear Stearns, the fifth largest investment bank in the capital market of United States (US), announced that two of its mortgage investment funds, worth about $US1.5 billion, had literally no value left in them, because of gambling on debt securities linked to sub-prime high-risk home loans made people on low wages and with incomplete credit histories (Nason, 2007). Though the sub-prime mortgage lending market has decades of experience, particularly in the US home buyer market, the attractiveness of sub-prime loan markets emerged in the US through the change of Federal legislation during 1980-82, when the interest rate caps were removed and lenders were allowed to offer adjustable rate mortgages (Kiff & Mills, 2007). In 1986, the tax act of the US was reformed again, which left residential mortgages as the only consumer loans on which the interest was tax-deductible (Kiff & Mills, 2007). In particular, this prompted ‘refinancing of mortgage’ or ‘home equity withdrawal’ as a preferred means of loans for personal consumption and home improvements, in contrast to other forms of consumer loans, and this flexibility of borrowing to consume against housing collateral was like installing an ATM machine on the side of the house (Klyuev & Mills, 2006).

One of the attractive features of this kind of loan is the provision of ‘automated underwriting’, which reduces cost of the lending. In practice, this ‘automated underwriting’, by using computer modeling, estimated cost savings of up to 3% of the approved capital substitutes in the traditional method (Fig. 2) of lending decisions, where individuals are solely responsible for approval of loans (Bies, 2003).
A new model of lending practice has been popularised (Fig. 2) with the rise of sub-prime mortgage financing to replace traditional mortgage management. The modus operandi of this model allows lending institutions to sell-on mortgages to the bond markets, which makes it much easier to fund additional borrowing than the traditional procedure (BBC, 2007).

In fact, over time, sub-prime mortgages emerged as a distinct type of lending practice, particularly among the lower and lower middle income population of the US housing market. This explosive growth of the sub-prime market was also facilitated by the ‘securitisation’ of assets, which apparently shifted the credit risks, and as a consequence a significant rise of home ownership was evident during the 1990s in the US economy (Kiff & Mills, 2007). In the US, from 1994-2005, the sub-prime home loan market grew from US$35 billion to US$665 billion, and in 2006 it was US$640 billion (Fig. 3). This implies that one in every five home loans originated was a sub-prime lending (Leonard, 2007).
In the first instance, a ‘common shock’ was extended to a few global economies but subsequently there was a second push, in the form of ‘spillover effects’ or ‘contagion’, where the impacts of the shock on the US economy were transmitted elsewhere in the world (Brown & Davis, 2008). The ripple effects of US sub-prime mortgage lending crisis incurred huge losses of many bonds and credit derivatives in financial markets and collapse of high-rated credits have badly affected bank balance sheets, which have now reduced the value of the top quality mortgage-backed bonds by 25 per cent (Kaletsky, 2008). Citigroup Inc. the biggest US bank by assets, will close all of its 32 branches in Japan after reporting losses and write-downs from the sub-prime mortgage crisis totaling US$42.9 billion (Chicago Tribune, 2008).

**Why Did the Sub-prime Lending Break Out as a Crisis?**

Sub-prime mortgage lending practices, though benefited particularly individuals with bad credit, first-time home buyers, and other low- or zero-income borrowers, exposed mortgagees to higher interest rates with hidden costs, high penalty rates for non-payment of installments, etc., and at the end of the day foreclosures (SP Loan Source, 2008). In practice, the securitisation process of capitalist enterprises
dispersed credit risk at each stage of lending processes and concentrated on the remuneration earned by generating loan volume, ignoring the quality, even as the credit spreads on the resulting securities shrank (Kiff & Mills, 2007). Schloemer et al. (2006), in a study on sub-prime lending between 1998 to 2006, argued that about 2.2 million sub-prime loans failed, which cost around US$164 billion in foreclosures of homeowners in the US. Their study also reveals the factors related to sub-prime loans. According to this study, first the growth of the sub-prime market, which comprises highly broker-originated loans, has led to a rise in risky loan products and looser standards for qualifying borrowers; second, in the lending processes little or no emphasis has been given to viability; and finally, there are defective legal and regulatory consequences for offering loans that are predictably unsustainable.

The sources of capital of sub-prime lending are manifold. In the US capital market, the prime source of capital is investment banks such as Credit Suisse, Goldman Sachs, JPMorgan Chase, Lehmans Brothers, Morgan Stanley, Residential Funding Corporation and UBS Real Estate Securities Inc. (Connor, 2008). For instance, in 2006, ten investment banks (Fig. 4) controlled as underwriters 70% of the $486 billion in sub-prime mortgage securitisations in the US market (Connor, 2008).

**Figure 4: 2006 Sub-prime Securitisations by Underwriter (adopted from Connor, 2008).**
In 2006, in the US, rises in housing prices, coupled with skyrocketing interest rates, forced sub-prime borrowers to sell their houses to prepay mortgages and in most cases left them with no choice but to default on repayment where refinancing options were not feasible with little or no housing equity (Kiff & Mills, 2007).

But the crisis grew worse in everyday global financial markets. The news spread like wildfire, frightening the major lending firms, which led them to hunt for capital sources throughout the world. For instance, Merrill Lynch and Citigroup, who suffered severe write-offs, have been trying to raise US$21 billion from funds in Singapore and Saudi Arabia (Beams, 2008).

The Sub-prime Crisis and its impact on the Global Capitalist Economy

Some optimists insist that the mortgage market crisis in US does not necessarily have a strong influence on other property markets around the world (Foster, 2007). But in the wake of the crisis global evidence does not support these views. Fannie Mae and Freddie Mac two largest US home funding houses after billion dollars losses were bailed out by the US Federal government in view of recapitalize and boost the morale of the investors (CHINA daily, 2008). This Treasury bailout of Fannie Mae and Freddie Mac failed to stop the downward spiral. The International Monetary Fund (IMF), in their World Economic Outlook Report 2008, forecast that the US sub-prime crisis has caused universal catastrophe, affecting both developed and developing countries (Datamonitor, 2008a). In reality, sub-prime lending has considerable influence over the global capitalist economy. The IMF (2008) has projected a downward trend of global growth to 3.7 percent in 2008, which will remain unchanged in 2009. Warren E. Buffet is concerned about the US sub-prime home loan crisis. He urges that ‘the US economy would continue to face headwinds from the credit squeeze sparked by the collapse of the sub-prime or higher risk lending market…. the effects of the credit crunch are far from over at all. … there will be plenty of rippling secondary, tertiary effects’ (Buffett, 2008). In fact in recent times world has already seen collapse of Lehmans Brothers due to bankruptcy, renationalization of two largest US funding houses: Fannie Mae and Freddie Mac due to
countless losses, collapse of AIG the largest insurer and everyday global media is tired of broadcasting the rollercoaster ride of the volatile capital market. Warren Buffet had to come forward with a $6 billion package to rescue Goldman Sachs.

Recent developments in the US show that losses will exceed $285 billion and have an impact on borrowers, lenders, appraisers, mortgage brokers, trusts, title companies, underwriting firms, renting agencies, publicly traded companies and even their leadership all over the world financial sectors (Miller, 2008). The crisis also had a severe effect on the US construction market in 2007, which expects significant inflation in 2008 (Grogan, 2007). It is also noteworthy that at present each day sees two private lawsuits related to sub-prime mortgages (Chung, 2008). In May 2008 payrolls fell by 49,000 and the jobless rate increased by half a point to 5.5%, which deepened the economic crisis in the US (The Age, 2008). To overcome the crisis the US government takes several steps to restore calm to chaotic financial markets, such as Goldman Sachs and Morgan Stanley have got approval to become bank holding companies regulated by the US Federal Reserve, which might enable them in taking deposits and buy retail banks more easily and it also a move that ends the traditional investment banking model (bdnews24.com, 2008).

The US federal government also proposed a draft for bailout plan to purchase mortgage-related assets to face the credit crisis (The New York Times, September 21 2008). At present this rescue plan is with the US congress and the amount may grow up to US $700 billion investment that would exceed the cost of Iraq war (Montgomery & Cho, 2008).

In the United Kingdom, two prime mortgage firms, DB mortgages and West Bromwich Building Society, decided to withdraw their entire sub-prime mortgage range and residential mortgage securitisation deals respectively due to the US sub-prime crisis in August 2007 (Powley, 2007). The Royal Bank of Scotland and Bradford & Bingley had already announced rights issues to amend their damaged balance sheets (Seib, 2008). In Canada, the losses of the six largest banks stand at approximately $11 billion, roughly 5% of the total global bank write–down (Roseman, 2008). The Chinese ‘dragon’ is also slightly hit. Even a highly controlled market like China is affected by the crisis, where it has stalled financial liberalisation
China also pulled back its offered IPOs (initial public offering) from the market because of weaker investor interest, valuation concern and unstable capital markets (Qimeng & Marianne, 2008). ‘China’s economic growth rate would be less than one percentage point lower if that of the US slowed down by one percentage point’ (Ma Jun, chief economist for Greater China at Deutsche Bank AG in Hong Kong, 9/4/2007). The US economic downturn also has limited impact on the profitability of the listed firms in China’s equity markets as a whole. It can seriously affect eight percent of the total stock market capitalisation in the country.

In Sweden, the drive towards privatisation of iconic companies such as SBAB, a mortgage lender, Nordea (the banking group) and TeliaSonera (the telecommunications company) has been slowed down due to the sub-prime crisis (Ibison, 2008). In the Middle-East, major banks which have exposure in assets, such as Gulf International bank, Arab Banking Corporation and Gulf Investment Corporation, are in limbo, and have dramatically decreased in value over the past 12 months in 2007 (Martin, 2008). Even Middle-East companies working on less profitable projects are suffering through delays or postponements of schemes because of a downturn in activity (Foreman, 2007). Capital enterprises around the world have also significantly weakened. For instance, UBS, one of the prime investment banks, has written off US$18.4 billion in 2007, and in April 2008 it announced a 19 billion dollar write down, which shows the devastating impact of the US sub-prime mortgage crisis (The Sydney Morning Herald, 2008).

The US sub-prime crash has imposed immediate pressure on Australian economy through the general repricing of risk by financial markets in Australia (Walker, 2008). Because Australia has a substantial deficit on the balance of payments in the current account, which is funded by international borrowings by financial institutions (Fig. 5), at present the crisis has largely stopped those borrowing (Belshaw, 2007). It is evident that over time Australia’s offshore as well as domestic liabilities have significantly increased. Therefore, dependency on offshore borrowing is a common feature of today’s capitalist economy, which will have devastating effects on economies that are highly interrelated.
Moreover, in Australia securitised housing loans have proportionately risen over time, which justify the offshore borrowing of Australian financial institutions (Fig. 6). Therefore, the interrelatedness of capital hunting around the world is a common feature of today’s capitalist economy. For example, Australian home mortgage lender RAMS, who largely raised funds using short-term commercial paper loans from the US, has found that its sources have dried up during the sub-prime crisis and as a result RAMS failed to refinance $5.4 billion in debt in August 2007 (Howarth, 2008).
ANZ Banking Group, one of Australia’s four largest banks, raised interest rates by 20 basis points in order to cover rising costs due to problems in the sub-prime market in January 2008 (Howarth, 2008). In December 2007, Centro Properties one of the largest owners and managers of the shopping malls in the US and Australia struggled to refinance its debts ($1.14 billion in long-term debt and $1 billion in joint-venture debt), after traditional finance options dried up because of the US sub-prime crisis (Howarth, 2008). Wayne Swan, the Australian Federal Treasurer, admitted the negative impact of the crisis on Australian economy. According to him, ‘the US sub-prime crisis has been pushing up the cost of borrowing on international capital markets and of course this is the context in which recent mortgage rates have increased … Australia does face a serious inflation challenge as well as the fall-out from the US sub-prime crisis’ (Swan, 2008). As a consequence, indicators of the Australian economy show that a significant downturn in financial activities has emerged over the period of time of the crisis. But its impact will be moderate as the regulatory regime in Australia is much more effective and disciplined unlike the US system. Many observers including the former Australian Treasurer has pointed out that the failure of the regulatory regime is one of the factors for this Tsunami in the financial sector.

Tata Consultancy Services (TCS), India’s largest IT outsourcing company, has been hit by two large contract cancellations from Wall Street banks in the latest sign that the sub-prime crisis is pressuring the world economy. India’s largest private-sector employer did not say which customers were affected. It is thought that they are Citigroup and Merrill Lynch, as these two US banks have taken a hit of more than $40 billion between them in the wake of the sub-prime crisis and could yet announce more writedowns. The growth of the Indian ‘tiger’ economy may slow down as India’s IT industry is massively exposed to the West’s financial sector, which is by far the largest user of its services. European and the US banks are also cutting down or freezing IT budgets this year and is already planning to move more work to cheaper countries to cut costs (Blakely, 2008).
The Magical Faith in Market is under Question

The economic downturn in 1987, 1997, and 2001 did not take place in the epic-centre of the world capitalist system. This crisis originated at the core of the world financial centre. Collapses of Lehman Brothers, the US$85 billion rescue package for American International Group (AIG), the bail out of Fannie Mae and Freddie Mac, alongside the forced selling of Merrill Lynch and Warren Buffet’s intervention to rescue Goldman Sachs raise a serious question about the sustainability of the present form of global financial markets. The sub-prime debacle and the subsequent crisis has damaged markets and institutions, curtailed liquidity, weakened capital adequacy in major banks, and prompted the repricing of risk across a broad range of sectors (IMF, 2008). But no significant reforms have been anticipated apart from a few piecemeal initiatives as first-aid treatments of financial market casualties. Such as, the Bank for International Settlements (BIS)-an international organisation which fosters international monetary and financial cooperation and serves as a bank for central banks proposed the Basel II capital framework to improve market transparency and internal value-at-risk models particularly for banks to justify any factors used in pricing which are left out in the calculation of value-at-risk (The Bank for International Settlements, 2008). But nothing can protect the market in melting down. Therefore flawed remedial policies have opened space for more catastrophes. We order our lives to produce and consume commodities, which give us profits and create interests, but to understand globalisation and its problems conceptualisation of the capitalist economy is a must, because its ultimate objective is accumulation of more and more wealth (Robbins, 2008). After the failure of the planned economy of communist states it was thought that government should be kept out of the way of any financial management but this strategy also failed. Indeed over the last few decades the world capitalist order has faced a series of problems which have struck particularly the global financial system (Beams, 2008). The global financial architecture has some deep-seated weaknesses, which need to be addressed (Stiglitz, 1999). This is because financial market operations around the global capitalist system are being inflated by a collapse of confidence (Beams, 2008). Also the political pendulum is in full swing but economies are yet to develop
any practical understanding as to the facts surrounding the origination of the related loans in regard to the sub-prime debacle (Pardes, 2008). To assess the whether there was any fraud that facilitated this disaster FBI is now looking at 26 cases of potential corporate fraud related to the collapse of the U.S. mortgage lending industry. FBI Director Robert Mueller told the U.S. Congress a week ago that 24 cases of potential corporate fraud were under investigation, up from 21 disclosed by the bureau in July (bdnews24.com accessed on 25 September 08).

To overcome the sub-prime crisis some economists argue that there should not be a ‘public bailout of borrowers, lending institutions that made loans to unqualified individuals, firms that bundled those mortgages as investments and the investors that voluntarily gobbled them up’ (ENR, 2007). Mervyn King, the Governor of the Bank of England urges that banks need to put up billions of pounds for a consumer compensation scheme to save investors (Seib, 2008). Kiff & Mills (2007) suggest that imposing a capped liability on the mortgage assignee is needed to counter the predatory features of mortgage loans. Indeed, present depredations of financial capital and the neo-liberal ‘free market’ doctrine reveal the necessity of a return to regulation (Beams, 2008). An international regulatory body is being suggested by many economists to address any future economic catastrophes. A risk-management practice model and a watchdog body need to be instituted to avoid the disastrous impact of similar financial ‘tsunami’. As a response to this crisis the Secretary Paulson proposed a blueprint that would require modernization of financial regulations. The Federal Reserve would require power to authorize to take a closer look at the operations of companies across the financial spectrum and ensure that their practices do not threaten overall financial stability (The New York Times, 24 September 2008).

A risk management regime with a global financial regulator can then assist financial services institutions to re-evaluate their enterprise risk strategy and leverage regulatory driven technology spend into operational risk based performance management to obtain competitive advantage (Datamonitor, 2008b). Engel and Patricia (2007) also emphasise contractual provisions to shift the credit risk partly or fully to the lender to guard against the credit and litigation risks of predatory loans. According to the IMF (2008),
expenditure restraint, vigilant financial supervision, promoting appropriately tight lending standards and strong risk management can help financial management of global capital enterprises. Though the IMF considers appropriate fiscal and financial policies are needed in preventing a sub-prime crisis (IMF, 2008), what sort of fiscal policies could save the global economy at present and in the near future are yet to be devised.

World political and corporate leaders are trying to counter the malignancies of sub-prime mortgage lending and its aftermath. Remedies such as greater transparency of lending procedures, accountability of management, tightening of regulatory framework, etc., are in today’s financial management carriage. But, in general, whenever crises appear, these common remedies emerge again and again. Should global leaders stipulate a single dose for all economies around the world to save global alliance capitalism? It is hard to find a long-term sustainable strategy to counter the blanket arrest of global economic development. The ‘magical faith in the market’ needs to be revisited. Globalisation debate has mainly focused on globalisation of markets and products. Global financial transactions and the invisible hands of questionable innovative mafia entrepreneurs in those operations are not yet under any global regulatory institution. Existing multilateral institutions are mainly concerned with the political and social issues, including governance. No serious debate has yet been launched to manage the global debt market. An unregulated international debt market can bring a tsunami-like crisis to the world economy. The energy crisis, global warming and climate change, along with the conspicuous nature of global capital markets, are likely to accelerate a global recession.
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