The first global financial crisis of the 21st century: Introduction

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Introduction

Global financial markets are showing strains on a scale and scope not witnessed in the past three-quarters of a century. What started with elevated losses on U.S.-subprime mortgages has spread beyond the borders of the United States and the confines of the mortgage market. Many risk spreads have ballooned, liquidity in some market segments has dried up, and large complex financial institutions have admitted significant losses. And bank runs are no longer the subject exclusively of history.

These events have challenged policymakers, and the responses have varied across region. The European Central Bank has injected reserves in unprecedented volumes. The Bank of England participated in the bail-out and, ultimately, the nationalization of a depository, Northern Rock. The U.S. Federal Reserve has introduced a variety of new facilities and extended its support beyond the depository sector.

These events have also challenged economists to explain why the crisis developed, how it is unfolding, and what can be done. This volume compiles contributions by leading economists in VoxEU over the past year that attempt to answer these questions. We have grouped these contributions into three sections corresponding to those three critical questions.
1. Why did the crisis happen?

Although it is tempting to complain that the crisis was inevitable, some articles emphasize the inherent uncertainty in predicting the future. Dell’Ariccia, Igan, and Laeven discuss the role of uncertainty in the subprime lending boom. Persaud and Danielsson both discuss the overreliance on standardized quantitative risk models. Lastly, Wyplosz counsels caution when analyzing the crisis and its causes in the face of high uncertainty.

Several articles search for the roots of the crisis in public policy—either monetary or regulatory. On the monetary side, Cecchetti argues that monetary policy did not unduly increase risk-taking before the crisis. Boeri and Guiso believe the opposite. Ioannidou et al. avoid directly blaming the Federal Reserve for the crisis but do present empirical evidence that low interest rates—like those present in the U.S. in 2003 and 2004—encourage ex-ante risk-taking. Baldwin discusses the view of Martin Feldstein that the low U.S. saving rate and overinvestment in housing must inevitably lead to a fall in the value of the dollar. Cardarelli et al. argue that financial innovation has led to the business cycle becoming more sensitive to changes in house prices, and that monetary policy did not sufficiently take this into account.

Other articles focus on the regulatory system. Tabellini blames some of the problem on the fragmented nature of the U.S. regulatory system. Spaventa focuses on the growth of off-balance sheet banking activity and argues that regulators both missed the explosive growth of financing mechanisms like Structured Investment Vehicles and failed to see the hidden risks to the banking system that these unconventional instruments created.
Several authors reach beyond the recent past to understand the present. Wolf compares current conditions to that of 1930s Europe and its exit from the gold standard. Bordo and Reinhart both put the current crisis into historical perspective.

2. How is the crisis unfolding?

As the crisis opened in late summer 2007, economists disagreed on its likely magnitude. It initially appeared to be a simple liquidity problem. Monacelli thought that the problems were extensive but benign. Calomiris thought that “there is little reason to believe that a substantial decline in credit supply under the current circumstances will magnify the shocks and turn them into a recession.” Buiter thought that the Federal Reserve’s first rate cut in September 2007 was unnecessary owing to the fiscal policy response.

Buiter also cautioned everyone to remember the difference between “inside assets,” which are a zero-sum game that just transfer money between parties, and “outside assets,” which are real assets that lack an offsetting liability. Vives suggested that the problems in modern markets such as asset-backed commercial paper, auction-rate securities, etc., directly parallel, and require the same response as an old-fashioned banking crisis: Bagehot’s wisdom to lend freely against good collateral at penalty rates. However, Ubide presciently spelled out a variety of reasons why what appeared at first to be a simple liquidity problem masked far deeper credit pathologies. Cristadoro and Veronese wrote about the difficulty of tracking economic growth in real-time, which was an extra source of confusion.
Some authors tried to anticipate possible paths by which the crisis could spread. Gros wondered if European house prices—which in some countries had risen even more quickly than U.S. prices—are vulnerable to a similar slump. Snower tried to anticipate some of the possible international spillover effects from the U.S. problems. In another article, Snower outlined four “mega-dangers” to the financial system and suggested that our surprise at continued crises is more surprising than the crises themselves.

Cecchetti continued his FAQ series with updates on the unprecedented Federal Reserve responses to the freeze in the money and credit markets. These included the largest single cut in the federal funds target rate since the early 1980s, currency swaps with foreign central banks, and three new lending mechanisms: the Term Auction Facility, the Term Securities Lending Facility, and the Primary Dealer Credit Facility.

Monacelli published two articles critical of the European Central Bank’s decision to cut interest rates, saying that they lacked transparency and increased inflation risk. However, Widgrén argued that the ECB was too slow to react, and institutional differences with the Fed made the ECB less able to respond quickly during a crisis. Wyplosz agreed that the Fed was more innovative than the ECB and quicker to react.

Several articles deal with currency movements. Corsetti argues that the U.S. trade deficit will be more responsive than in the past, helping restrain the dollar’s fall. However, Baldwin summarized a Krugman article predicting a “pretty far and pretty fast” dollar decline.
3. What can be done?

VoxEU has published several articles with policy suggestions to prevent this kind of crisis from happening again. Information dissemination was a key theme. In August, Onado focused on three aspects that later commentators would return to: credit ratings, evaluations of asset marketability, and transparency in the retail market for financial assets. Giovannini and Spaventa urge greater dissemination of information and rethinking of the Basel II accord on bank capital requirements.

Buiter wrote a series of articles on the policy lessons from the U.K.’s Northern Rock debacle. He blamed both policies and institutional arrangements, including an ineffective deposit insurance scheme, poor regulatory coordination and division of responsibilities, and weaknesses of the supervisory standards embodied in Basel II.

Portes wrote on regulatory reform, covering ratings agencies, sovereign wealth funds, and financial institutions. Hildebrand also wrote about sovereign wealth funds, advocating that they adopt a voluntary code of conduct. De la Dehesa urged more regulation of mortgage brokers, greater transparency, and methods to overcome banks’ principal-agent problems. Persaud said that regulators need to accept that the commoditization of lending means that instability is built into the financial system and regulators need to proactively pursue counter-cyclical policies.

The future of monetary policy and central banking was also a recurring theme. Leijonhufvud argued against inflation-rate targeting on the basis that the central bank could still find itself diverging from the Wicksellian ‘natural rate’ of interest that should be the central bank’s goal. De Grauwe contended that inflation targeting restricts banks’
ability to restrain asset bubbles, while Assenmacher-Wesche and Gerlach warned against trying to use central bank policy to stabilize asset prices.

Buiter and Sibert advocated the expanded use of liquidity policies rather than monetary easing. They think that central banks should act as the “market maker of last resort.” Spaventa also proposes that the government should purchase illiquid securities, likening his proposal to the Brady Plan that unfroze the Latin American debt markets in 1989.

Finally, thinking about currency arrangements has never been far from hand. Frankel wrote that the euro could surpass the dollar as the world’s reserve currency within a decade, while Eichengreen warned that a breakup of the euro system would “trigger the mother of all financial crises.”

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