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

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The First Global Financial Crisis of the 21st Century: Part II, June-December, 2008
Andrew Felton and Carmen M. Reinhart, eds. (London: VoxEU and Centre for Economic Policy Research, February, 2009).

Introduction

Sadly, our previous compilation of VoxEU columns, 'The First Global Financial Crisis of the 21st Century,' was not the last word on the subject. Since the publication of that volume in June 2008, the global crisis has both deepened and widened. The industrial world has seen the largest bank failures in its history, and many governments have intervened in the financial system in a manner that would once have been unthinkable. Wall Street and the City of London, along with most other financial centers, have been changed forever. Many storied financial firms have failed or been merged away, and others are left with significant ownership positions of national governments. The economy of Iceland has suffered a collapse just as sizable as any of Latin America or East Asia during the last few decades.

Vox authors have kept up their prolific pace of commenting on unfolding events. In keeping with the mission of Vox, columnists both applied existing economic research to understand events and pointed the way to new avenues for research. These articles, it has to be understood, were written 'in the moment' over the past six months and so incorporate to a varying extend the history we have lived through. To help place individual contributions within this historical

sequence, an appendix updates the timeline of events from our June publication through December. Another appendix provides a glossary of technical terms.

As we did last time, we have divided the Vox columns into three thematic groupings. Columns in the first group describe how the crisis spread around the world and necessitated international coordination. The next group is about how the ciris has upended traditional thinking about financial economics. The final group of columns includes a plethora of policy critiques and proposals.

1. The spread of the crisis to the rest of the world

Perhaps the most notable recent development has been how quickly and forcefully the crisis has spread to the rest of the world. Danielsson provided a comprehensive account of the country hit hardest by the crisis, Iceland. The krona fell by more than 95 percent against the dollar and the nation's banking system is devastated. Lane thought that these events will propel Iceland into the arms of the European Union, a policy that Zoega thought was the only sensible prescription. Buiter and Sibert, who have been writing about Iceland for more than a year, called its downfall the 'predictable end of a non-viable business model.'

Reisen predicted that emerging markets are still vulnerable to contagion and that they would try to rely less on private debt in the future. Reinhart and Reinhart identified a systematic predictor of a variety of crises in a large set of countries over the past few decades. Economies receiving large inflows of capital, termed 'capital flow bonanzas,' often run aground when those flows stall. Calvo and Loo-Kung wanted a preemptive bailout of emerging markets to cut off calls

for protectionism and nationalization. As equity markets plunge in unison around the world, Hesse examined how the wealth effect differs among countries, and found that the stock market wealth effect is smaller but still significant in emerging economies. Freytag and Pehnelt wanted to use the financial crisis to spur reform in emerging-market debt relief programs. In two articles, Subramanian discussed the credit crunch's impact on India and suggested that the government use its foreign exchange reserves to stabilize the economy.

Several columns discussed the need for coordinated international action. Muellbauer argued forcefully for a large, internationally coordinated interest rate cut. Others focused on intra-Europe cooperation. Gros and Micossi called for a European Financial Stability Fund to issue euro bonds to recapitalize the financial system. Di Noia suggested that Europe create a new financial regulatory system based on the four objectives of macroeconomic stability, microeconomic stability, investor protection and competition. Pagano's article was also in favor of a Euro-area bank supervisory authority. Taking a broad view, Rossi's philosophical piece discussed the impact of financial globalization on the role of the state and regulation.

Gros pointed out that many European banks are too large for their national governments to save and floats a few ideas about how to improve cross-border financial regulation. Persaud pointed out that the inability of national governments to save their banks will likely increase fiscal integration in the euro area.
Gros and Micossi suggested that the ECB obtain the power to directly support large European banks and that Europe develop a cross-border rescue fund. Laeven

and Levine were more skeptical of one-size-fits-all plans, demonstrating how banks adapt to their local environments, especially with regard to corporate governance laws. Bertola and Lo Prete discussed how financial globalization and the current crisis will negatively impact welfare programs around the world. Although the 2005-era concerns about current account deficits now seem like a distant memory, Forbes reminded us that the dollar remains vulnerable and reliant on external funding. Reinhart and Reinhart pointed out that this foreign funding continued this year, even though the United States has been the epicenter of the financial crisis. This follows because large foreign official holdings of U.S. government debt has made the United States too big to fail, lessening external discipline on the policy response. Eichengreen questioned whether the IMF will have a useful role to play in this crisis – and if it does not, what that portends for its future status. He suggested that the Fund increase its lending to middleincome countries to help them through the current liquidity squeeze.

2. What is wrong with the traditional economic/financial viewpoint and models?

To many Vox columnists, the ongoing crisis has highlighted glaring omissions in economists' understanding of financial markets and institutions. The view that asset prices should equal their risk-adjusted expected return means that the smartest minds, with huge incentives, mispriced a huge variety of securities. The Vox contributors pointed out a number of current events that undermine traditional theories of finance; as Dale quipped, the current crisis 'is an academic crisis

too.'

Many of the problems had to do with transparency, principal-agent problems, and other forces keeping the purchaser of assets from understanding their underlying properties. Kiff, Mills, and Spackman discussed a number of problems with the European securitization market. Pagano explained how the opacity created by securitization led to surprisingly high systemic costs. Cohen focused on agency problems, which he said lead to a 'Panglossian' attitude in the financial sector. Sinn blamed limited liability laws, which he said encourage excessive risk taking, especially in the financial sector.

Mariano discussed transparency of ratings agencies, and found that their reputation concerns might not be enough to assure accurate ratings. Instead, reputation effects could cause ratings to be too conformist, too conservative, or too bold, and it is difficult *a priori* to find out which of these will result. Goodhart presented the view of the Financial Economists Roundtable on a variety of proposed reforms of the ratings industry.

Another aspect of financial markets brought to the forefront by the current crisis is that of liquidity: how easy it is to trade an asset. Pedersen explained asset liquidity – a concept not incorporated into most economic theories based on expected value. Persaud also wrote about liquidity and how a problem in subprime mortgages, less than 1 percent of the world's debt stock, caused a cascade of failures throughout the financial system. González-Hermosillo, and Hesse examine various liquidity channels through which the problems spread beginning in 2007, including ABCP, SIVs, and interbank lending. Freixas and Parigi said that the

increased importance of liquidity and interconnection of banks makes the central bank's role as a lender of last resort even more important. Persaud argued against suspending mark-to-market accounting and proposes mark-to-funding accounting instead, which would weight market prices of assets by the durations of their offsetting liabilities.

The complexity, rapid growth, and interconnection of markets has prevented analysts from producing either a simple explanation of the crisis or a simple way to restart economic growth. Heinemann discussesed the crisis in light of recent theoretical work on the possibility of asset price bubbles and game theory, particularly that of Princeton's Markus Brunnermeier. The work implied that a coordinated global signal is needed to get investors buying again.

Danielsson discussed the role of complexity in the crisis and tells regulators to focus on simple variables, like the leverage ratio. Bloom argues in two articles that the previous goodwill toward complexity has morphed into risk aversion and uncertainty, which will deter investment and likely lead to a severe recession that monetary and fiscal policy are powerless to avoid. One of the driving regulatory forces toward complexity was Basel II, which Repullo and Suarez found reinforced pro-cyclical capital requirements. Goodhart agreed that counter-cyclical policy is needed, although he focuses on the role of central bank policy. Giovannini said that a single regulatory policy cannot apply to universal banks, and advocated splitting them into 'client servicers' and 'capital managers.'

Coutert and Gex looked back to 2005, when the bankruptcy of auto parts supplier Delphi caused a minor crisis in the credit default swap market, for lessons

applicable today. The show that correlations on CDS spreads rose during the crisis, leading to potential contagion issues today after the recent bankruptcies of Lehman Brothers, etc..

Giavazzi discussed the puzzling spread between LIBOR and the expected path of policy interest rates, which was implying default rates far higher than even the most determined bear would predict. He pointed out that some banks may be deliberately withholding funds from the market in order to weaken competitors.

3. The proper governmental response

Eichengreen emphasized that, despite the temptation to blame the crisis on greed and corruption, policy has an important role to play in both explaining the cause and getting world markets out of it. Calomiris provided a useful overview of both private and public actions that precipitated the turmoil. Rancière urged policymakers not to throw out the baby of innovation and risk-taking out with the bathwater of systemic risk. Berglöf and Rosenthal warned Europe not to proclaim the end of capitalism too quickly, pointing out that many of the modern U.S. problems have their roots in policies enacted in the wake of earlier crises. Corsetti and Müller provided an overview of theory and simulations on the effectiveness of different types of fiscal policy versus monetary policy. Gros argued that governments should prefer to implement fiscal policy via tax cuts rather than infrastructure development. Castanheira advocated fiscal stimulus combined with explicit targeting of expanding future budgets deficits in order to manipulate expectations. Boltho and Carlin focused on Germany, which they said needs a

large financial stimulus despite being in better shape to weather the crisis than many other countries.

A number of columns discussed the United States' Troubled Asset Relief Program (TARP) and related government bailouts and guarantees. Zingales stated flatly that it wouldn't work. The problems of the banking sector were too large to pay for without cutting other necessary spending to prop up the real economy and provide debt relief to underwater homeowners. Wyplosz provided a half-hearted defense of the plan, however, as did Spaventa.

When the TARP was first announced, a flurry of columns came to a similar conclusion:

the real need was to recapitalize the banks rather than buy illiquid assets.

Persaud advocated a debt-for-equity swap. Buiter similarly focused on the need to recapitalize the banks. Acharya discussed the pros and cons of various recapitalization approaches, as well as related regulatory infrastructure improvements.

Zingales discussed why existing bankruptcy procedures might exacerbate the problem, but mentioned some game-theoretic problems with a pure recapitalization. Calomiris also wanted purchases of preferred shares to recapitalize the banks.

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Frankel summed up the 'emerging consensus.' Onado discussed bank recapitalization through the metaphor of Achilles and the turtle: banks losses were rising more quickly than capital could be acquired.

Cesari advocated the creation of an alternative to the TARP focused on debt

relief and increased regulation. Boeri suggested three ways of broadening the bank bailout plans to ensure more benefits for the general public: increase competition in the financial industry, reduce low-income tax rates, and provide mortgage debt relief.

Other discussion centered around how much to pay for troubled assets or charge for guarantees. Pagano discussed the theory of reverse auctions, which were to be the main policy tool of the TARP. Gros used option theory to show that if homeowners exercise their default options ruthlessly enough, then subprime mortgage securities could be mostly worthless.

Suarez discussed the necessity of government guarantees of bank debt just as a number of countries were launching similar programs. Acharya and Sundaram focused on how the United States and United Kingdom were pricing their bank debt guarantees and found that the U.S. guarantee was much more favorable to the banks than the U.K. guarantee was. Gros and Micossi discussed the impact of direct bailouts, such as of AIG, and how European banks were too big for any one national government to save.

Wyplosz contrasted the 'Larry Summers' approach, keeping investors from taking flight, with the 'Willem Buiter' approach to making investors stomach the risks they knew they were taking. de la Dehesa alerted us to the difference between a credit 'crunch,' in which the quantity of credit is lessened, with a 'squeeze,' in which the adjustment is on the price side, and concluded that the euro area—at least in July–was suffering neither.

Some columns discussed governmental responses to past crises. Claessens et al

found that recessions instigated by financial crises are usually much longer and deeper than those from other causes. Laeven, who collected results mostly from prior studies, reported that the average crisis costs about 15 percent of GDP – which would be more than $2 trillion in the United States alone. Kobayashi recapped some of the mistakes that Japan made during the 1990s, specifically with regard to the choice about recapitalizing ‘zombie’ banks. Similar to Gros and Micossi, he called for a global ‘Financial System Stabilisation Fund.’ Eichengreen compared the current situation to the Great Depression and finds sobering similarities. Hughson and Weidenmier discussed the importance of a lender of last resort in the historical context of seasonal liquidity crises before the Federal Reserve.

Finally, Duflo managed to find a potential silver lining to the crisis: high salaries in the financial sector have attracted many of society’s brightest minds, which will now have to refocus on more socially useful activities.

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