

From Subprime to Banks to Sovereign Debt – Dealing with the Crisis

Marshallplan Jubiläumsstiftung, 21 October 2010

Wolfgang Münchau, Eurointelligence

Where did the problems start?

Bad regulation?

Not enough regulation?

Easy money?

Irresponsible politicians?

Bad regulation? Not enough regulation?

1. Not really that plausible since the problems arose in the most regulated sector on earth – the banking sector.
2. Basel 1 rules not sufficient, but the problems would have surfaced also under a Basel 2 framework.
3. Would the shadow banking regulation drawn up in the EU and the US right now have prevented the crisis? Perhaps helpful, but hardly sufficient.

Easy Money?

1. Not really that plausible either. Monetary policy played a role, but cannot be solely responsible, not even the main cause of the crisis.
2. Question: How high would US interest rates needed to have been during 2002-2004 to prevent the subprime bubble: probably 5%.
3. No central bank policy framework – inflation targeting, monetary targeting, dual pillar frameworks – would have suggested such an excessive high rate.

Irresponsible politicians?

1. If the Responsible Politician is an oxymoron, then the Irresponsible Politician must be a tautology.
2. We would be in severe trouble if global financial stability depended on responsible politicians.
3. Just look the current set of European leaders: Berlusconi, Sarkozy, Zapatero, Socrates?
4. In fairness, Berlusconi was, relatively speaking, more responsible than others.
5. But the causes of the crisis are not here.

So what are the causes?

1. My explanation: excessive global imbalances (and intra-eurozone imbalances in respect of our own eurozone crisis).
2. Current Account Imbalances = Capital Account Imbalances = > Strong cross border financial flows
3. The problem are not financial flows per se, but the combination of large cross-country financial flows and domestic banking regulation and domestic backstop responsibility.
4. In the presence of large global financial flows the causes of the crisis reduces to a classic Olson-style collective action problem.

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