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# Preface

This book is a selection of VoxEU.org columns that deal with the subprime crisis. VoxEU.org is a portal for research-based policy analysis and commentary written by leading economists. It was launched in June 2007 with the aim of enriching the economic policy debate by making it easier for serious researchers to contribute and to make their contributions more accessible to the public.

The subprime crisis, which boiled over in August 2007, was the perfect showcase for Vox's unique approach. Mainstream media's explanations of it as a liquidity crisis did not seem to fit the facts. How could a few deadbeat homeowners in the United States bring down a German Landesbank, force a restructuring on a major French bank, and compel the Fed and the European Central Bank (ECB) to undertake emergency injections of cash? The story was surely deeper than a standard-issue credit problem.

Starting on 13 August 2007, Vox posted a slew of columns by economists who really knew what they were talking about and were willing to explain the crisis in terms that any trained economist could understand. Mainstream media's limits (800 words written for the average newspaper reader) just did not work for an event of this complexity. Vox provided commentators with the space to explain the situation using standard economic terminology. It raised the level of the public debate and this attracted researchers who had also been at the cutting edge of policy-making, such as: Willem Buiter (professor at LSE and former member of the Bank of England's rate-setting Monetary Policy Committee), Steve Cecchetti (professor at Brandeis University and former Executive Vice President and Director of Research at the New York Fed), Charles Wyplosz (professor at the Graduate Institute, Geneva and adviser to central banks), Marco Onado (professor at Bocconi and former Commissioner of the Italian public authority responsible for regulating the Italian securities market, CONSOB), Tito Boeri (professor at Bocconi and editor of *LaVoce*) and Luigi Spaventa (professor in Rome and former Chairman of CONSOB).

On behalf of CEPR and the Vox editorial board, I would like to thank Carmen Reinhart for agreeing to edit this compilation of columns. Together with her colleague at the University of Maryland's School of Public Policy, Andrew Felton, the result is what follows, a primer on what is probably the worst financial crisis of our generation.

Richard Baldwin, VoxEU.org, Editor-in-Chief and CEPR Policy Director  
June 2008



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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 US subprime mortgages has spread beyond the borders of the United States and the confines of the mortgage market. Risk spreads have ballooned, liquidity in some market segments has dried up and large complex financial institutions have admitted significant losses. Bank runs are no longer the subject exclusively of history.

These events have challenged policy-makers, and the responses have varied across regions. The ECB has injected reserves in unprecedented volumes. The Bank of England participated in the bailout and, ultimately, the nationalization of a depository, Northern Rock. The US 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.

## Why did the crisis happen?

The first set of articles contains reflections on the reasons for the crisis. Although it is tempting to suggest that the crisis was inevitable with hindsight, several articles emphasize the inherent uncertainty of economic analysis. Dell’Ariccia, Igan and Laeven discuss the role of uncertainty in the subprime lending boom. Persaud and Danielsson both caution against the overreliance on standardized quantitative risk models. Finally, Wyplosz counsels prudence when analysing 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. Cecchetti has a series of ‘Frequently Asked Questions’ about the extraordinary monetary policy actions taken to alleviate the crisis. He argues that crises are endemic to modern economies and should not necessarily be blamed on monetary policy. A well-functioning financial system needs both deposit insurance and a central bank with regulatory authority, he says. Boeri and Guiso disagree, blaming the crisis on low US interest rates. Ioannidou et al. avoid directly blaming the Federal Reserve for the crisis but present empirical evidence that low

interest rates, like those present in the United States in 2003 and 2004, encourage ex-ante risk-taking.

Other articles focus on the regulatory system. Tabellini blames some of the problem on the fragmented nature of the US regulatory system. Spaventa focuses on the growth of off-balance sheet banking activity and argued that regulators both missed the explosive growth of financing mechanisms like structured investment vehicles (SIVs) 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. Bordo, starting from 1921, finds that turning points in the credit cycle often correspond to turning points in the business cycle as well. Reinhart reviews five major financial crises in industrial economies and concludes that the current economic problems have a great deal of precedent.

## **How is the crisis unfolding?**

The next section consists of articles discussing the events as they unfolded. As the crisis opened in late summer 2007, economists disagreed on its likely magnitude. It initially appeared to be a simple liquidity problem. The Federal Reserve introduced a number of novel policy responses in its role as lender of last resort role, detailed in a continuation of Cecchetti's FAQ series. These policies 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 thinks that the liquidity problems are 'extensive but benign'. Calomiris contends 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 judges the Federal Reserve's first rate cut in September 2007 unnecessary, because of the fiscal policy response under way.

Buiter also cautions 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 suggests 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, namely the central bank should lend freely against good collateral at penalty rates (as Bagehot's classic wisdom suggests).

However, Ubide presciently spells out a variety of reasons why what appeared at first to be a simple liquidity problem masked far deeper credit pathologies. Snower tries to anticipate some of the possible international spillover effects from the US problems. In another article, Snower outlines four mega-dangers to the financial system and suggests that our surprise at continued crises is more surprising than the crises themselves.

The section ends with another article by Cecchetti that summarizes the Federal Reserve's reactions to date. Wyplosz admires the Fed's innovation and speed, contrasting it to the more cautious ECB.

## **What can be done?**

VoxEU.org has published several articles with policy suggestions to prevent this kind of crisis from happening again. One major theme was enhancing information dissemination. 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 contributes a series of articles on the policy lessons from the United Kingdom's Northern Rock debacle. He blames 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 writes on regulatory reform, covering ratings agencies, sovereign wealth funds and financial institutions. De la Dehesa urges more regulation of mortgage brokers, greater transparency and methods to overcome banks' principal-agent problems. Persaud says 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 is also a recurring theme. De Grauwe contends that inflation targeting restricts banks' ability to restrain asset bubbles, while Assenmacher-Wesche and Gerlach warn against trying to use central-bank policy to stabilize asset prices. Buiter and Sibert advocate 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 proposes that the government should purchase illiquid securities, likening his proposal to the Brady Plan that unfroze the Latin American debt markets in 1989.