

**THE SUBPRIME CRISIS: AN OVERVIEW OF SOME  
LESSONS AND  
POLICY IMPLICATIONS**

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**The Setting, Risk, Mispricing, Agency Failure and Asymmetric  
Information**

The crisis started as a basic credit shock in a narrow market segment, the US subprime market and was triggered by a combination of rising costs and falling housing prices.

The initial conditions for the crisis: typical in the history of financial crises

Key favourable factors that boosted housing prices:

The post 1987 era of "Great Moderation" (low volatility in inflation and a sense of reduced risk for long term assets)

declining of the risk premium on long term assets

dramatic shift to excess savings in the emerging world

Shifts in the financial system away from commercial banks to non-deposit taking institutions.

Development of new instruments and derivatives  
Extrapolation of "good fundamentals" boosted credit expansion, fostered liquidity, lowered financial volatility, boosted risk tolerance, leverage and intermediation.

A number of factors added to systemic risks:

A perception that institutions are "too big to fail"

Laxed criteria in extending credit

Underpricing of credit and liquidity risk

Management risk failed to keep pace with the financial innovation

Wrong incentives driving the credit expansion were multiple and mutually reinforcing.

**Financial Crises: Lessons from History**

Financial crises in the last twenty years:

Stock market crash, October 1987

Exchange Rate Mechanism (ERM) of the EMS, 1992-93

The Tequila crisis, 1994-95

The Asian crisis, 1998

Russian crisis, 1998

Brazilian crisis, 1999

The Dot. Com crash, 2000

Latin American Crisis (Argentina, Brazil, Uruguay 2001-2003)

US subprime crisis, 2007.

**Key lessons:**

Different underlying causes

Globalization has increased the frequency and spread of financial crises, but not necessarily their severity, though the jury is still out on the current crisis.

Early intervention is more effective in limiting their spread

Swings in commodity cycles

Difficult to forecast turning points of the crisis

Regulators often cannot keep up with the pace of financial innovation

Lack of liquidity

### The Decoupling Debate

Historically, the conventional view was that financial turmoil in big, advanced countries would spread to other countries, including the emerging ones.  
"when the US gets flu the rest of the world catches pneumonia".

Before the current crisis, for a variety of reasons, a wide-held view was that emerging markets are decoupling from developments in developed economies.

This idea of decoupling has NOT been confirmed by the facts.

Yet, can the idea of decoupling come back in the upswing? - decoupling 2.0?

### The Policy Response

A series of unprecedented policy responses from central banks:

Broadening of the function of the lender of last resort

Bail out institutions

Policy interest rates close to zero

Quantitative easing (ie expansion of Ms)

Governments embarked on huge stimulus packages and bailout programs.

Questions raised around govt finances, size of budget deficits, potential higher taxes, borrowing costs and inflation.

### An Economic Policy Perspective

|An overview of the policy initiatives in the last fifty years shows an oscillation between fiscal policy and monetary policy which appeared to be "costless"

1950s - 1970s: Keynesian demand management, fine tuning, inflationary pressures, excessive govt involvement etc.

Mid-1980s shift to monetary policy, easy monetary policy, low interest rates did not ignite inflationary pressures - was it the insight of central bankers or deflationary forces from China and India and gains in productivity?  
It did create rising debt levels and asset bubbles.

The current crisis demonstrated that conventional monetary policy has not been enough. In addition to controlling inflation, other objectives such as watching asset inflation, bailing out banks, additional supervisory measures are being debated.

The fiscal packages and bail-outs have also raised questions of 'externalities'- who is going to bear the costs - and of moral hazard.

Critical voices about the Economics as a discipline.

### Financial Reform

Plenty of debates are currently taking place, hence, any remarks are rather speculative.

Broaden regulation for banks, other financial institutions, even firms (hedge funds, private equity firms)

Broaden the system of supervising financial institutions, greater disclosure.

Monitor "systemic risks" and "excessive risk"

Adapting the current regulatory system or introducing new institutions?

Broaden the system of supervising cross-border institutions around the world and problems thereof.

Higher capital requirements and rules on capital and liquidity

The question of bonuses and executive pay is under scrutiny

Talk of a "social contract" between banks and society and changing bankers' attitude.

### Conclusion

The current financial crisis has raised numerous issues and have had an impact on almost every sphere of human endeavour.

It is still too early to know the final impact of the crisis on the various issues under debate and the lessons drawn from it.

Thank You!