

The financial crisis: What happened and why?

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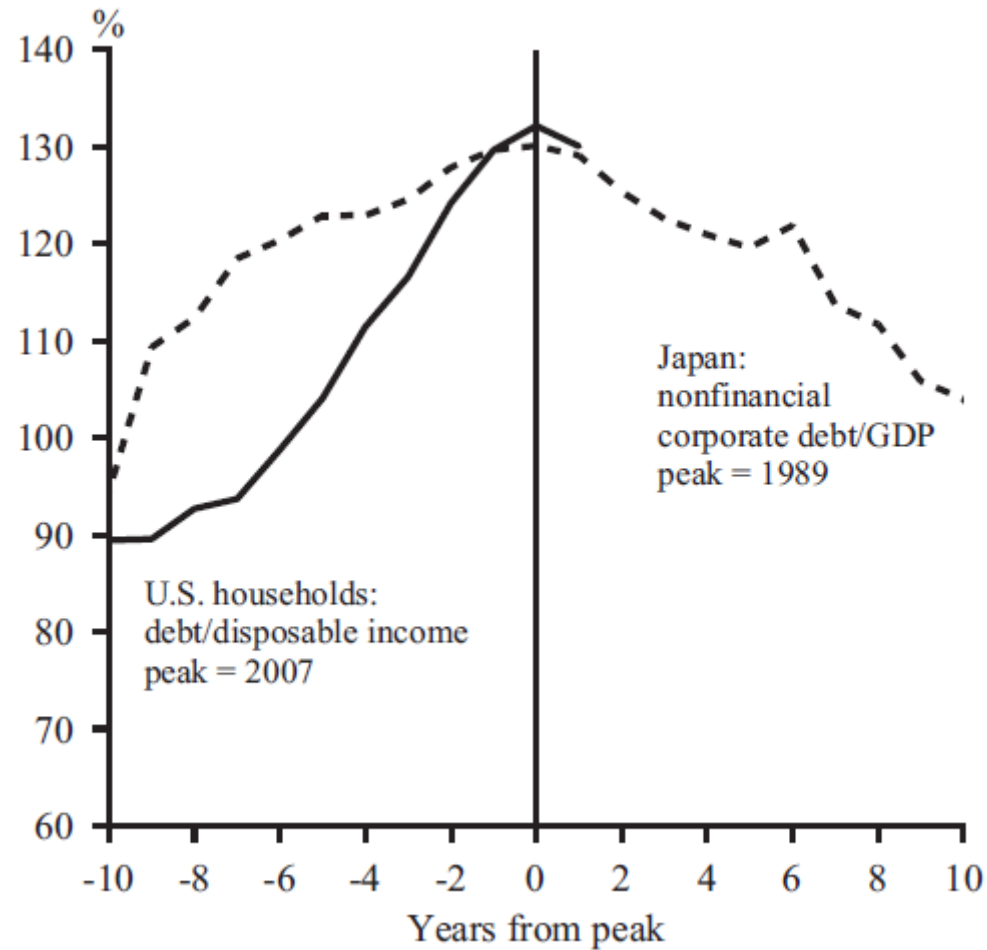
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**Public Hearing
of the
Special Committee on the Financial, Economic and Social Crisis
European Parliament
Paul-Henri Spaak Building, Room P1A002
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What happened?

- A classic financial crisis: boom/bust
 - Boom: credit expansion and asset price bubble
 - Bust: asset price tumble and debt default
- But on a massive scale ('global')
 - Size: A big boom => A big bust
 - Scope: US and Europe

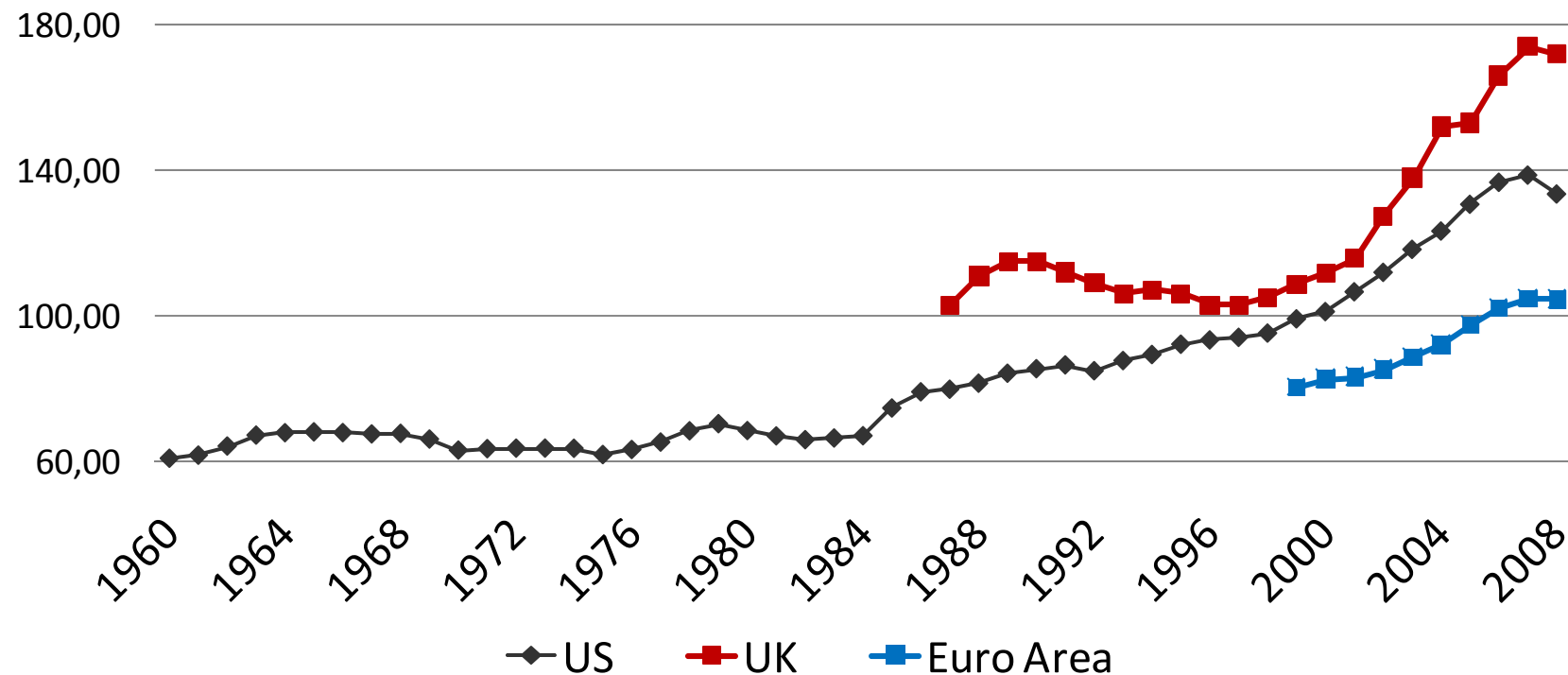
Debt ratios: US versus Japan



Source: Krugman (2009)

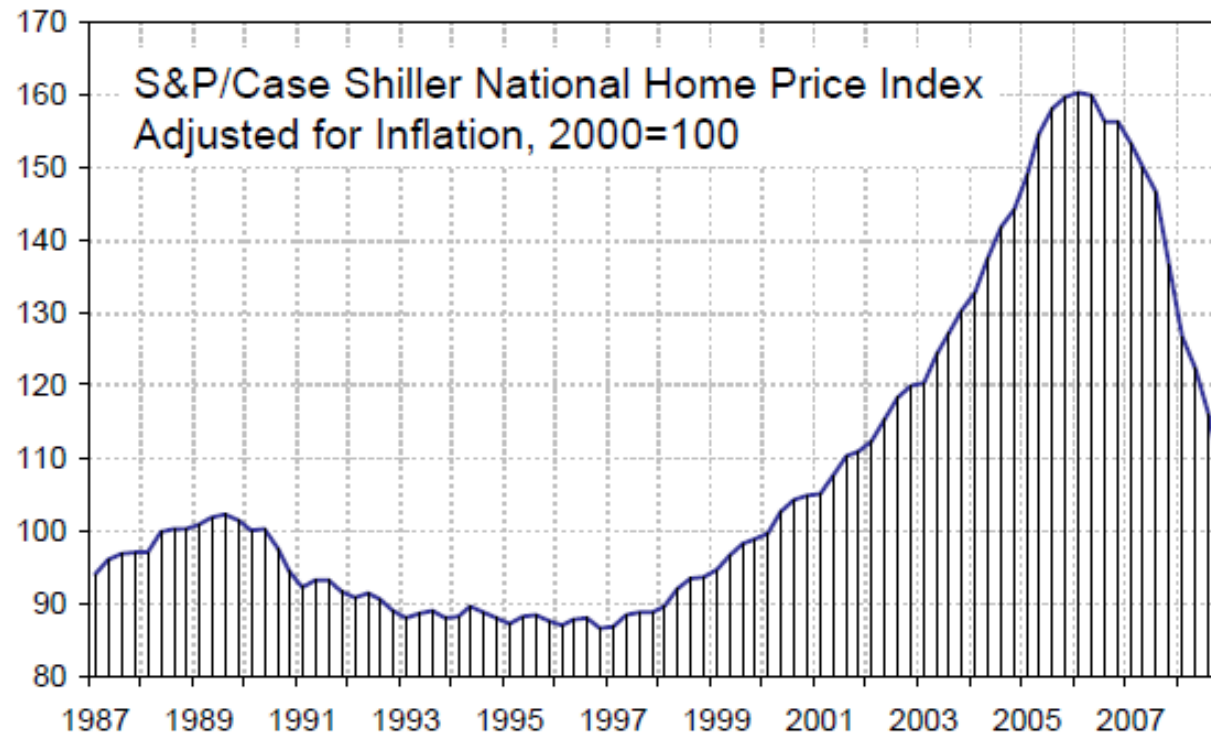
Household debt 1960 – 2008

(in percent of gross disposable income)



US housing market: bubble and crash

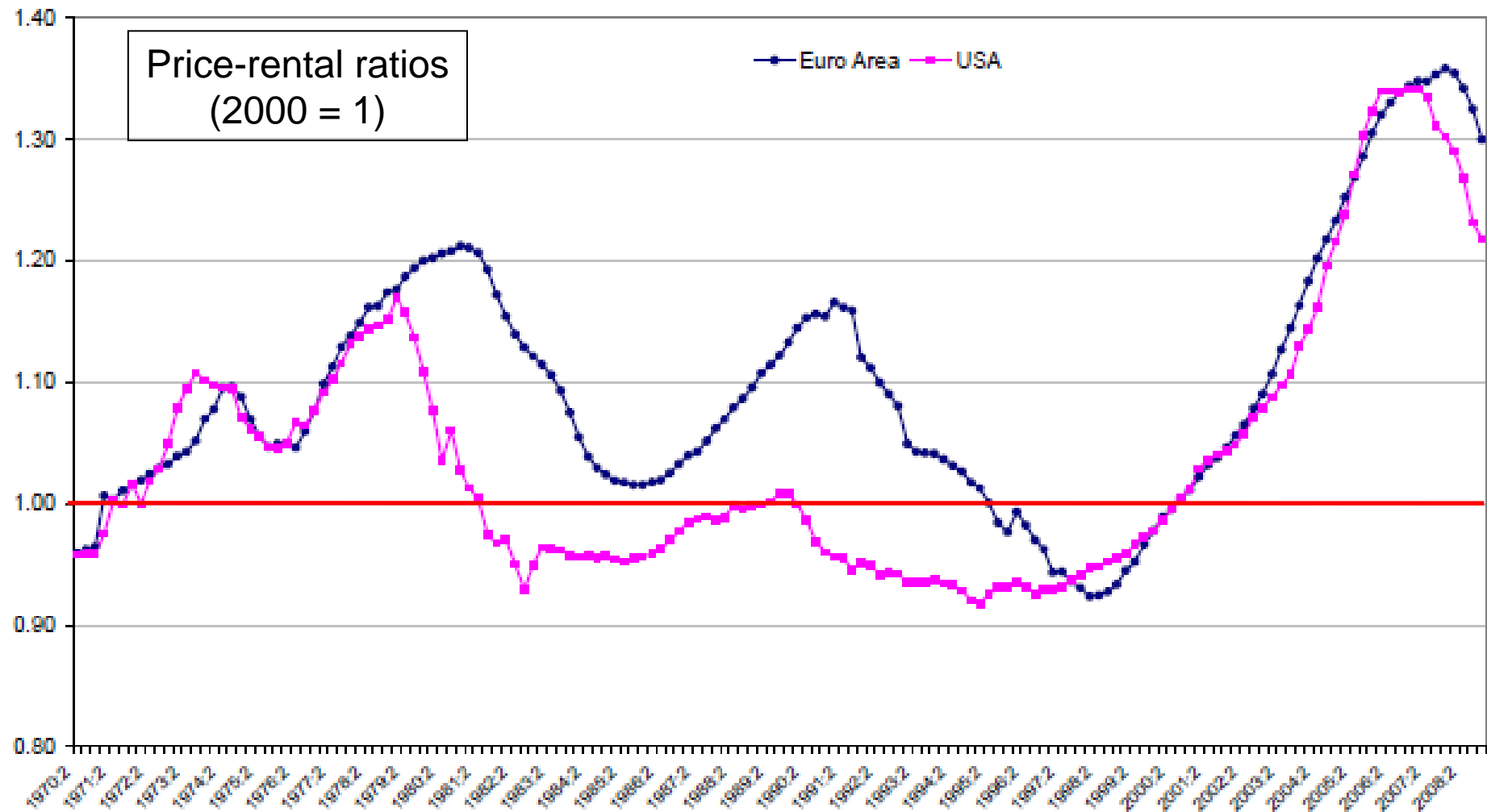
S&P/Case Shiller National Index-Inflation Adjusted



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& POOR'S**

The housing price bubble: Europe also

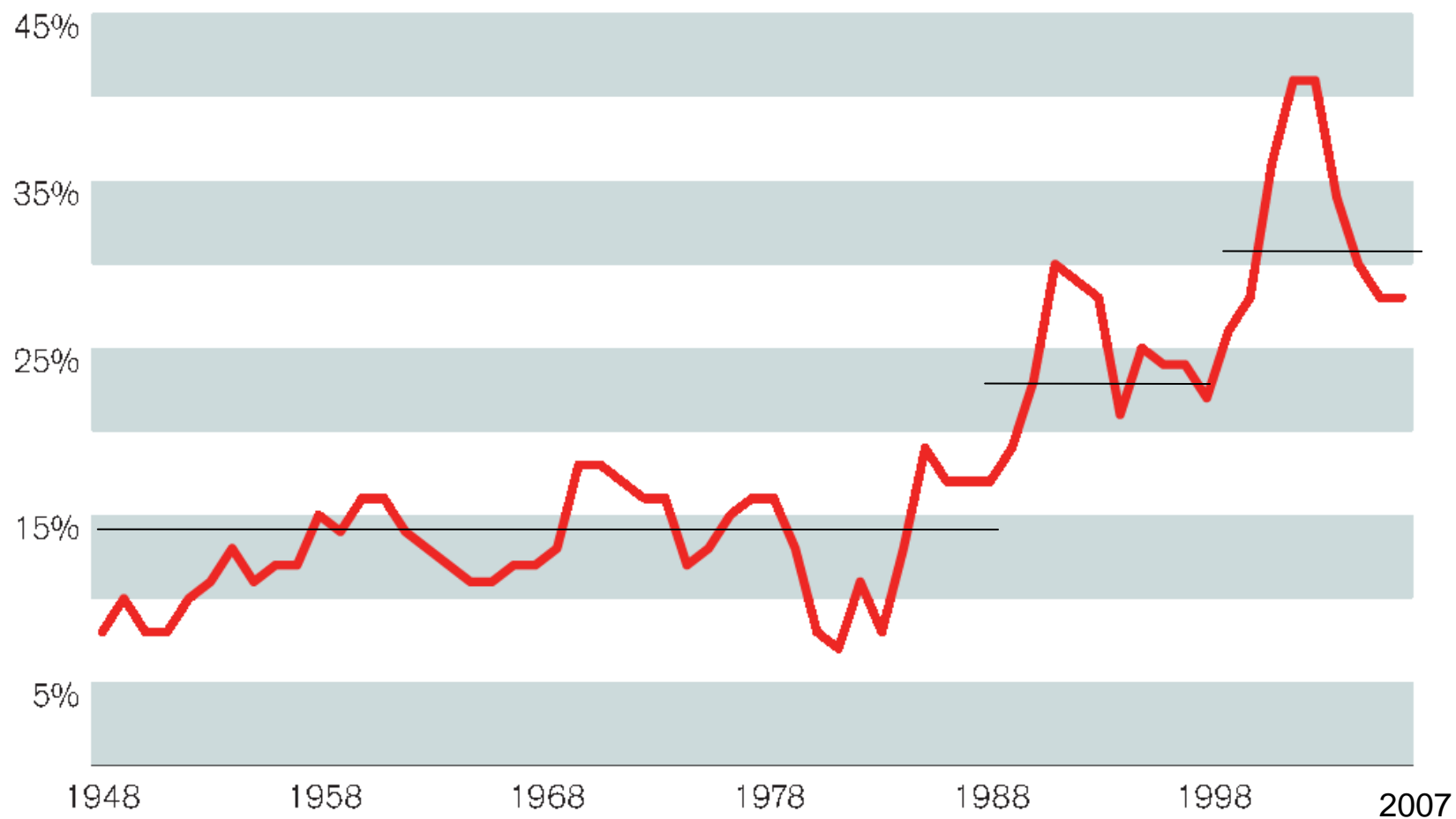


Source: Daniel Gros (2009)

Why it happened?

- Excessive risk taking. Why?
- Financial causes
 - Innovations: Inadequate understanding
 - Regulation: Inadequate regulation
 - Supervision: Inadequate supervision
- Macroeconomic causes
 - Good times
 - “Success breeds a disregard of the possibility of failure” (Minsky)
 - Monetary policy: cheap money
 - Global imbalances: more cheap money

FINANCIAL-INDUSTRY PROFITS AS A SHARE OF U.S. BUSINESS PROFITS



Source: Simon Johnson, The Atlantic, May 2009

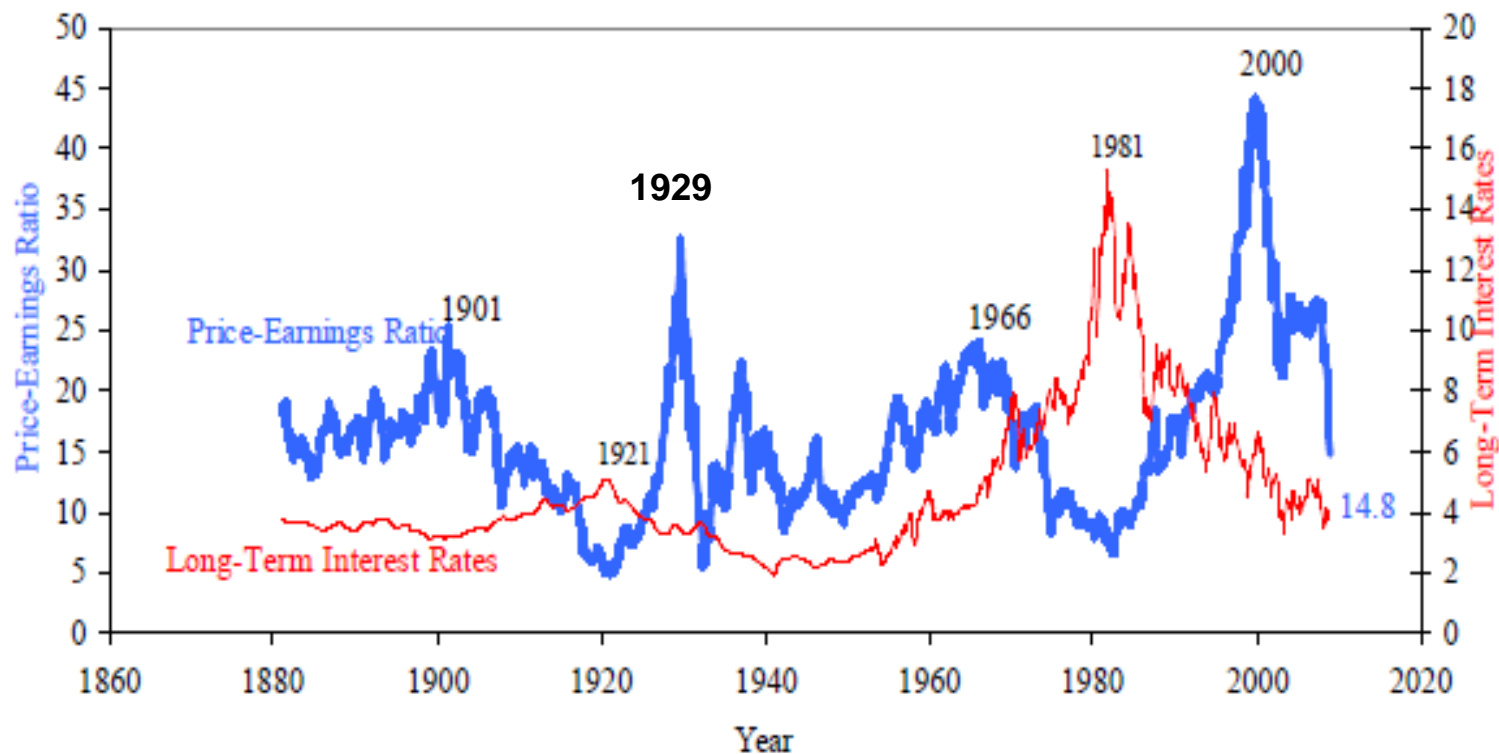
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Good times in the 1990s

- 1996-2000: Dot-com stock market bubble
 - “Irrational exuberance” (Alan Greenspan, 1996)
 - Low inflation, less uncertainty, low risk premium, high stock prices
 - Technological change + globalization, new opportunities, high stock prices
- 2001: the stock market crash
 - Fear of deflation => expansionary macro policies

Secular US S&P price-earnings ratios



Source: Robert Shiller

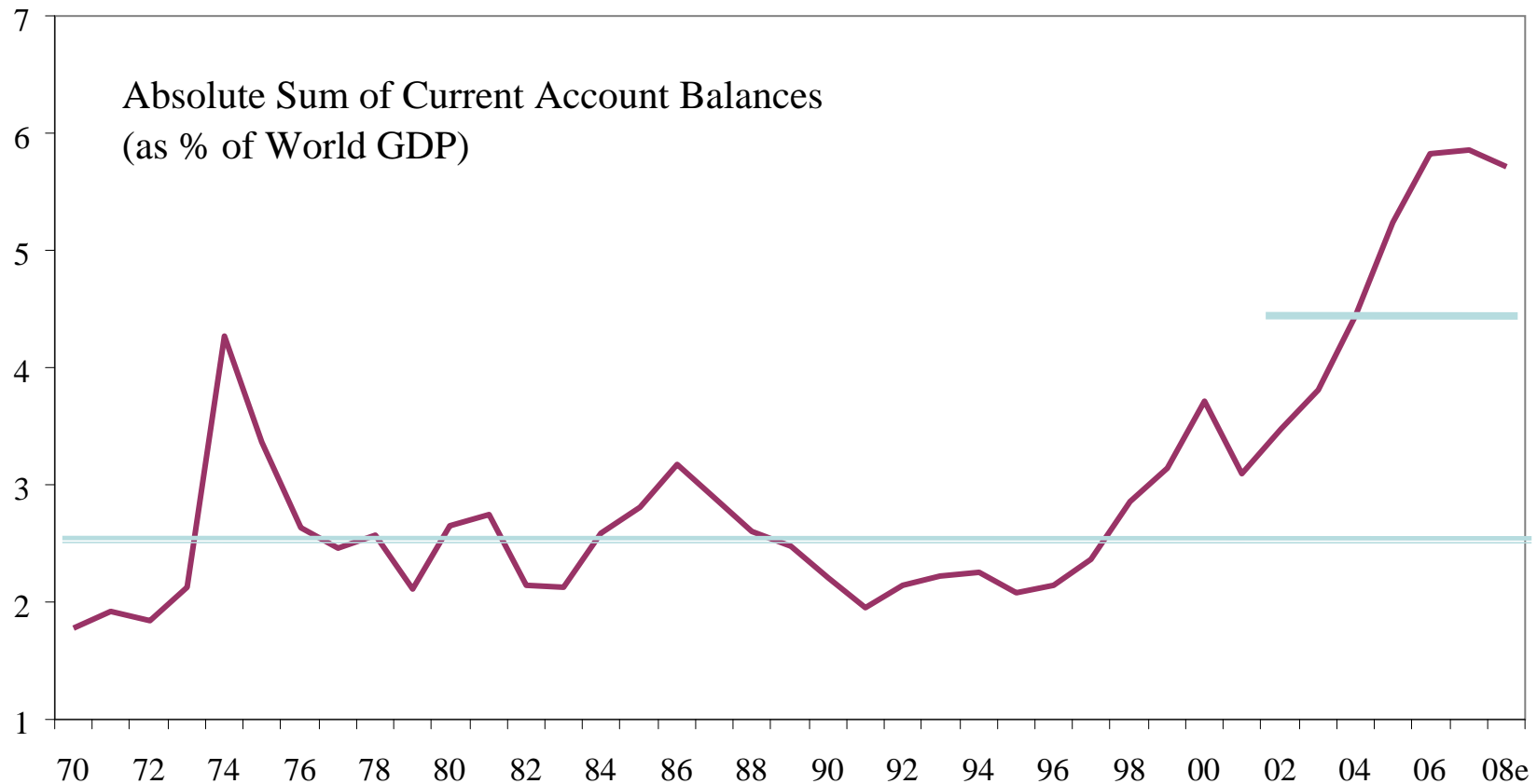
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- 2001: the stock market crashes
 - Fear of deflation => **expansionary macro policies in 2001-2002**

More good times in the 2000s

- 1998-1999: Asian crisis
 - Leads to: savings/reserve accumulation => CA surpluses
 - CA deficits elsewhere, mainly US
 - Special place of the US economy
 - Size of the economy
 - Size of financial markets
 - \$ is the main reserve currency
 - => Global imbalances, mainly between US and countries with underdeveloped financial markets: Developing Asia and later also oil exporting countries: Global savings glut in search of safe haven

Global imbalances, 1970-2008



Source: IMF and Morgan Stanley Research

Growing surpluses, 2000-2007 (\$ bn)

	2000	2007
Developing Asia	38.6	406.5
Newly Industrialized	38.9	103.6
Middle East	71.9	254.1
Japan	119.6	211
Germany	-32.6	250.3
Total	236.4	1225.5

Source: Krugman (2009)

Increase 2000-2007: \$1,000 bn, of which
\$600 bn in emerging countries