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1. Is Greenspan to blame and what part of him?

The reasons behind the build up of the financial crisis that started in August 2007 with the collapse of the U.S. subprime mortgage market are widely debated. On the final judgment the jury is still out. Among the many arguments that are brought forward, most prominent is the assertion that too much liquidity or too cheap liquidity fuelled the US housing market and the subsequent speculation with newly created financial products based on residential mortgage backed securities (RMBS).

No doubt, macroeconomic policies could have prevented the crisis from fully unfolding. It is true, over the last decade or so the Federal Reserve System (FED) widely ignored warnings about stock market and house price bubbles when they were inflating at the end of a long boom. However, with this approach the FED followed the almost globally accepted rule that monetary policy should focus the price developments of the goods in the traditional basket of inflation measurement and should not try to directly intervene to steer prices on stock markets or sectoral markets like housing.

Sure, very low interest rates after the collapse of the dot.com bubble in 2001 fuelled the prolongation of the housing boom. To increase home ownership at affordable prices was a political target as laid down in the "National Homeownership Strategy" (Whalen, 2008). Low interest rates are the most important instrument to favour investment in fixed capital including housing over purely financial investment. In addition, housing bubbles are a regular byproduct of expansionary economic policy and lasting boom phases without leading necessarily to speculative excesses in their financing that are spreading all around the world.

Additionally, to take on more risk by using the lever of low equity ratios for a given investment is not driven by low policy interest rates. The other way round is more convincing: an investor trying to squeeze a certain return over equity (say 25 %) out of an investment that yields only 5 % has to use a smaller lever, i.e., a less risky strategy, if policy rates and the rates for loans are low as compared to a situation where policy rates and the rates to be paid for his additional debt are high[1]. In other words, low interest rates charged by the central bank do exactly the opposite of what the hypothesis states: It reduces the attraction of purely financial investment and increase the attractiveness of real investment. This is why the now obsolete monetarist school of monetary theory assumed that “too much money chasing too few goods” would lead to inflation and not to deflation. Obviously, recent experience and evidence has shown that the real world economy is not functioning on such simple terms. However, to say exactly the opposite, namely that too much money will lead to too much financial risk is just plain nonsense.

Last but not least, low interest rates or too much liquidity in the United States cannot explain the infection of large parts of the rest of the world. With floating exchange rates liquidity doesn’t flow between countries and cannot spill over into regions were the dollar is not legal tender. Other regions, displaying bad and infected banks now, like the Euro area or United Kingdom, had a fully independent monetary policy after 2001 with much higher interest rates. Finally, Japan, to fight deflation, has had a zero interest rate policy for many years now without stimulating speculative excesses like in the United States.

[1] Savings and loans evidence if available...

2. Are Chinese savings to blame?

Many blame the willingness of the world and some developing countries, in particular China, to finance American profligacy at very low interest rates and due to their abundant “savings”. In other words, the huge deficit in the United States is interpreted as being the result of the decision of American households to consume more than they could afford and the decision of the Chinese households to save much more than the country could invest. However, this explanation is rooted in a brand of macroeconomic theory that has been refuted by evidence in many cases in the past.

There is no consensus in economic theory whether current account disequilibria should be approached mainly from the side of the trade flows or mainly from the side of the capital flows. However, the observation that since the beginning of this century capital has been flowing “uphill”, i.e., from poor to rich countries, while at the same time an increasing number of developing countries that are net capital exporters have achieved high growth rates, has raised serious questions about the theory on which the “Chinese savings” approach is based (UNCTAD, TDR 2008).

The traditional theories of economic growth focus on countries’ endowments in terms of factors of production and/or natural resources. Economies with more capital equipment and/or better-educated workers are expected to generate higher per capita income than countries with low-skilled labour and meagre capital equipment. Thus, in order to be able to catch up, poor countries need more capital. However, if the creation of capital is a function of the level of income, developing countries face the dilemma of not having enough capital precisely because they are poor. In other words, their savings are insufficient to free up a part of the domestic production potential for the production of capital goods. In such a world developing economies are not expected to grow fast enough to initiate a catching-up process before reaching critical benchmarks of savings and investment (Sachs et al., 2004). The attempt to fill this “savings gap” by capital inflows from countries with higher income and savings has guided traditional development thinking. The same is true for neoclassical models of growth. Similar to the savings-gap model, they predict a positive correlation between savings (equal to investment) and growth for a closed economy. In these models the Chinese savings are difficult to explain as China was growing at a neck breaking pace and had the highest investment ratio in the world.

By contrast, explanations of the relationship between savings and investment based on the work of Schumpeter and Keynes focus on the role of profits in the adjustment of savings and investment. An implication is that most of the adjustment to new price signals or changed spending behaviour is primarily reflected in profit swings, which influence the investment behaviour of firms. Improvements of the current account are possible which are due to price changes in favour of domestic producers. By increasing domestic profits, higher net exports will trigger additional domestic investment, and the income effects of higher exports and higher investment will generate higher savings.

In this view, an increase in savings is no longer a prerequisite for either higher investment or a current-account improvement and vice versa. Neither the American deficit nor the Chinese surplus in the current account is the result of voluntary decision of households and companies but the result of a complex interplay of prices, quantities and political decisions. For many reasons it is wrong to assume that a complex economy, with millions of agents with diverging interests, functions in a way that would be found in a Robinson Crusoe world. Hence, to blame “countries” for their “willingness” to provide “too many savings” results from the neoclassical error to analyse the world economy based on the behaviour of “one representative agent". Such an approach cannot do justice to the complexity and the historical uniqueness of events that may lead to phenomena like those that are called the global imbalances.

3. Why did the crisis spread to so many countries?

Nevertheless, the financial crisis that originated in the US quickly infected many other countries. If it was neither due to the spilling over of national liquidity to other countries nor to the fact that the global economy had to digest "too many savings" from the developing part of the world, which was the channel of infection? Obviously, important channels of an infection that starts with bad loans are the debtor-creditor relation between countries. A country that has accumulated huge arrears against other countries will not remain unaffected if the debtor country has not used the credited funds carefully and falls into crisis.

The deeper reason for the importance of this channel of contagion has to do with the lack of governance in the financial relations between countries trading with one another in the globalized economy. The last decade has seen a dramatic increase of debtor-creditor relations between countries (chart…). This is the phenomenon, which is sometimes called "the global trade imbalances". In fact, imbalances in trade between countries are always capital imbalances at the same time, as the country with a trade surplus has to credit the difference between his export revenue and his import expenditure to the deficit country. Losses of financial activities in the deficit countries or the inability to pay back the credited funds directly affect the surplus countries and their banking system.

The reasons for these growing divergences at the level of the country as a whole are to be found mainly in large movements of relative prices between tradable goods in general and between manufactured goods and commodities that are driven to a considerable part by speculation on financial markets. The growing disconnection of the movements of exchange rates with their “fundamentals” (mainly the inflation differential between countries) has produced widespread and big movements in the absolute advantage or the level of overall competitiveness of countries vis à vis other countries. These changes in the “real exchange rates” (see section…below) are clearly associated with the growing global imbalances (UNCTAD, TDR 2008). In addition, speculation driven overshooting of commodity prices in both directions impacted on the emergence of current account surpluses in commodity producing countries during the boom of the last five years. A third factor that explains part of the lasting imbalances between the “big three” (the US, Europe and Japan) is of a more philosophical nature: due to their activist approach in economic policies the United States have been playing the role of the global engine of growth for a very long time whereas Europe and Japan were unable to stimulate their domestic demand accordingly and preferred to “free ride” on the US fed global recovery.

Due to the high leveraged speculation in currency markets that produced significant misalignments of exchange rates, the global imbalances were directly part of the winding of the global speculative bubble. Beyond this direct involvement, however, the global imbalances explain the spreading of the infection into countries and regions without any housing bubble or other kinds of “unsound” domestic fiscal behaviour like Japan, Germany or Switzerland. These countries have to bear a considerable part of the burden of the deleveraging because their economic policy focused on increasing the “international competitiveness” of their industries without taking into account the implications of such a strategy on the ability of the deficit and debtor countries to cope with the international debt and the restoration of their international competitiveness at a later stage.

3. Greed and profligacy are to blame but politicians should anticipate it

Given all this, the global financial crisis was the result of a failure of international governance or the failure of the international community to give the globalized economy global and credible rules. There can be no doubt that the sudden unwinding of all the speculative positions in all the different markets was triggered by the bursting of the house price bubble in the US. But, and this is important to keep in mind, all of these bubbles were unsustainable and would have burst sooner or later.

The house price bubble itself was the result of the deregulation of the financial markets on a global scale. The spreading of risk and the severing of risk and the information about it was promoted by the use of "securitization" through instruments like residential mortgages backed securities (RMBS) that seemed to satisfy the investors' hunger for double-digit profits. At this point only, greed and profligacy enter the stage. Without weak regulation and all the deregulation of the last decades (Kuttner, 2007; Davidson, 2008) expectations on returns of purely financial instruments in the double-digit range would not have built.

In real economies with consistently single-digit growth rates those expectations are misguided from the beginning. However, human beings tend to believe that in their generation things may happen that never happened before and – temporarily - they fully forget the lessons of the past. This happened first during the stock market booms of the "new economy". Despite its crash in 2000 a wide range of investors began to invest their funds into hedge funds and “innovative financial instruments”. These funds needed to ever increase their risk exposure for the sake of higher yields with more sophisticated computer models searching for the best bets. While it was clear that *everybody can't be above average* (Kuttner, 2007: 21) and that the capacity of the real economy to cope with exaggerated house and commodity prices or misaligned exchange rates is strictly limited, the visibility only improves when the dust of a big explosion has settled.

The widespread use of complex computer models added to the opaqueness of many instruments. More important for the kind of “financial innovation”, however, was the naive believe in efficient market theories that did not include objective uncertainty but assumed well-informed buyers and sellers (Davidson, 2008).

"Securitization" of investments vehicles led to further risk concentration because it converted debtor-creditor relations (or insurer-insurant relation) into capital flow transactions by packing different types of debt for onward sale to investors in form of bonds all around the world (Fabozzi et al., 2007). "These bonds may also be known as asset-backed securities because the interest and return of principal they promise are based on the value of the underlying assets. Those assets could be the property, such as cars or homes purchased with the original loans, or accounts receivable, which are monies owed to the lender" (Morgan Stanley, 2002). Due to the opaqueness of these complex bundled “products” many "securitized" assets found their way into instruments qualified as low-risk. A global clientele invested in these bonds because the global imbalances had intensified the global financial relations and had created the need for financial institutions located in the countries with current account surpluses to hold the bulk of the toxic papers. In the first enthusiasm, the global distribution of these papers was seen as an indication of successful risk diversification. But the opposite happened: Financial "innovation" resulted in a concentration of risk since most of the "vehicles" were "securitized" by using assets that had similar default risks (Kuttner 2007: 21-22; and Economist 2008a).

Needless to mention, that credit-rating agencies totally failed. But it is mainly due to the microeconomic approach they usually take and their ignorance concerning macroeconomic and systemic factors on a global scale that they misunderstood the risk of so many participants playing on the same fragile bridge between the small real economy and a bloated financial sector.