Anatomy of the Great Recession: 2007-2010

From the ideology of the *invisible hand* to market failures

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1. Origins of the Great Recession

The 2007 global financial crisis arises from the formation of the speculative bubble in the US housing market. The so-called *subprime* loans market –low-quality United States mortgage credits– develop quickly because of both, loose credit conditions granted by financial institutions, and excess of credit derived from the world liquidity glut. The accumulation of current account surpluses of the oil-producer economies, as well as from emerging countries gave way to the hypothesis of the *general excess of saving* during period 1996-2004 that was formulated by *Ben Bernanke* in 2005[1] and revisited in September 2007[2]. According to the latter, the problem was not the US current account deficit for but rather the high propensity to save of the Chinese economy.

On the other hand, banks bought "packaged" financial assets, that is to say, complex, opaque and overvalued assets, which included *subprime* loans. When the property market was collapsed, it started a spiral of non-payments of *subprime* mortgages, which converted those "packaged" financial assets into *toxic assets* for its holders. All this, together with the increase of risks in the financial sector and the appearance of risks due to the *securitisation process*, had generated a crisis of confidence. Companies and some banks underwent also a sharp financial leverage that contributed to the development of speculative bubbles on the real estate market and, latter on, to the collapse of real (houses) and financial (shares) assets prices.

The financial crisis, however, was not an exclusive financial market's issue, but rather a more general problem related to the increased instability in asset markets as compared with that of markets of goods, because the aforementioned instability has generated expectations that were not fulfilled. In the US case, the increasing scarcity of land and the greater demand resulting form the expected increase in population and immigration created the false illusion of unbounded price increases in the housing market. In the European case, the robust financial positions of companies and households prevented from fearing any solvency crisis.

In summer 2007, however, lack of information among banks about the quality of credits and their reputation regarding solvency fully disappeared. The interbank money market get dry and risk premia sharply escalated. In September 2007, associated with the rescue operation of *Fannie Mae* and *Freddy Mac*, the illness which afflicted Europe changed dramatically of nature, and the crisis that, at the beginning, was perceived as a liquidity problem was evolving towards a confidence crisis. However, a systemic collapse was considered still very unlikely.

A year later, on 15 September 2008 the world was on the brink of ruin when the US Secretary of the Treasury, Henry Paulson, and the Federal Reserve let fall the investment bank *Lehman Brothers*. In this way they aimed, among other, at demonstrating that those who thought that the *big too fail* argument, when related to financial institutions, do not always apply. To leave fall *Lehman* meant rejecting such an argument and prevent that the *moral hazard* could work. In doing so, the Fed put at risk the systemic risk in order to comply with the principle of impeding the functioning of *moral hazard*.

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[1] Bernanke, Ben S. (2005): The Global Saving Glut and the U.S. Current Account Deficit. Speech delivered for the *Sandridge Lecture* at the Virginia Association of Economists, Richmond, March 10.

[2] Bernanke, Ben S. (2007): Global Imbalances: Recent Developments and Prospects. At the *Bundesbank Lecture*, Berlin, September 11.

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Up to the bankruptcy of *Lehman*, the economic recession followed the traditional path of previous US economic slowdowns during the post-war period. As in recent periods (1986-92) –not only in the United States, but also in the United Kingdom, Spain and Ireland– a recession was being incubated that was being fed by the fall in the activity in construction. However, the decline in the housing market was not the only factor that encouraged the deceleration, because the bankruptcy of *Lehman* as well as fears that the insurance giant *AIG* –that in the end was rescued– might have dragged along the principal US financial institutions and those of the European Union, converting into a reality the probability of a systemic financial crisis. The panic get installed into the stock exchanges, the stock-market value of banks collapsed, risk aversion increased, capital flows paralyzed, and investors looked for *safe havens* where to get protected.

The financial crisis, which had started as a liquidity and confidence crisis, was dangerously developing as a systemic one. The collapse of the world financial system was a real threat, and the crisis began to feed itself back. Banks were forced to restrict credits, companies and consumers expectations deteriorated, and economic activity was in a free fall. Consequently, banks saw increase credit failures and reduce credits even further. The fact that banks ceased to be provided liquidity among each other, as well as to the companies, made clear the emergence of market, regulation and financial supervision failures. Governments and central banks have filled in this vacuum and they took heterodox decisions such as nationalisations, transfers of funds of taxpayers, etc. Soon, globalisation extended the virus of the toxic assets quickly, except in some emerging countries and Latin America.

Despite all the above, more enrooted reasons of the global financial crisis have to be found in the removal of restrictions to free movement of capital, in the unbounded financial innovation and deregulation of the last 30 years –most particularly in the United States–, and in the *global excess of savings* (1996-2004), as previously indicated. Control mechanisms were smoothed out and conditions for banking and financial supervision sharply reduced. All this gave way to perverse incentives which were exploited by some banks' managers to make business. Financial markets, instead of managing financial risks –which constitutes its main function– created them in order to continue making business. In so doing, some of the so-called *financial innovations* simply became financial brigandage, pure barbarism. As from September 2008, the greater recession of the post-war period began, thousands of investors lost their savings because some economists and financial experts, who believed in the self-regulation of the financial markets, claim for decades that any kind financial innovation was always beneficial, even those which were fully free, completely deregulated.

2. Lessons that can be learned

There is no unanimity among economists concerning the main conclusions which can be drawn from the global financial crisis. In my opinion, there are at least three different views on what might have failed. On the one hand, ultraliberal ones like Alan Greenspan believe those financial crises are constitutive of human nature. As a result, and because financial markets have a memory of no longer than ten years, he expects a new financial crisis will meet the appointment with punctuality within ten years. Another view is that of the neoclassic ones; for them it is not the market who failed, but rather those regulators in charged of its control and supervision. In other words, the greed of financial institutions has been possible because politicians have permitted a complete lack of regulation in some markets and financial institutions. Finally, many of the neokeynesian economists continued to rely on the rationality of both investors and markets, and thought that they work correctly in general. Within this group, only a few have rejected the rational behaviour as a paradigm for the economic behaviour, and have placed the origin of the crisis in the failures of the market. Because of this, strengthening the government and the State has been for them the best guarantee of a smooth running of the markets and, therefore, to avoid economic disasters which would derive from those some financial institutions installed in the practice of economic anarchism.

Responsibilities for the global financial chaos are widely shared. Central banks and international institutions they did no foresaw the crisis or because they paved the way for it by allowing a policy of excess of liquidity. The rating agencies, in collusion with the financial institutions rated by them, deceived buyers of financial assets on the true value of the latter. It should be recalled that the day prior to its bankruptcy, *Lehman* had been rated by *Standard & Poor's* with the maximum rating (AAA). High-risk funds (*hedge funds*) worked in a completely deregulated and completely free environment. Bankers took out of their balances (*off-balance*) many liabilities containing doubtful risks. In the transition from managerial capitalism to global financial capitalism, many of their actors maintained a blind faith in the self-regulatory nature of free markets.

In spite of the above, I would like to draw some lessons, though provisional ones, from the global financial crisis. I think they could be organised around two main issues. On the one hand the issue of *moral hazard* in financial economics; and, on the other hand, on *market failures* and the ideology of *the invisible hand*.

1. *The argument of the type "too fail to big" is indefensible when there is not, in return, an iron regulation policy*. On the contrary, unless we implement such a policy, we allow *moral hazard* to play a role in the world financial system, that is, we are creating the wrong incentives for the financial institutions to take risky decisions, which they would never had taken unless they were sure that, in the end, the negatives consequences of those actions would had been assumed by the economic authorities. Some economists think that we have top live now with a financial system in which *moral hazard* applies. On the contrary, other economists claim that to rescue a bank and make sure that such an action does not create *moral hazard*, it is enough to put into jail its managers, to introduce sanctions, and to penalise its shareholders.

2. *The crisis has also displayed the limits of the "delegated supervision approach"*. It is not true that only a reduced part of the financial system, as it is the case of commercial banks, needs regulation, control and supervision. Although in some cases *more* regulation is not necessary, in other cases –namely, in the US– a *better* financial regulation is needed. This will allow a clearer and quicker assumption of responsibilities, and will contribute to put an end to *smooth regulation* in the international finances.

3. *The crisis has demonstrated that the statement according to which one has to leave in peace financial institutions because they know what they are doing is simply false*. This is why the issue of limiting the powers of banks is at stake now. We are facing a crisis of wisdom and moral responsibility, which has paved the way to create the conditions to feed the US real estate speculative bubble which, in turn, has generated a huge instability in assets markets. In the global financial crisis, banks have been unable to know to which extend its balances were polluted with *toxic assets*. On the other hand, *rating agencies* have not done well their job, and still are a US oligopoly.

4. *To believe that the world of finance moves by principles and exact laws like physics leads to wrongdoing and excesses that pay those who have anything to do with it*. Systems based on financial markets similar to the US one, have a destabilizing capacity on the general finances very superior to that systems based on mainly based on banks, such as the European or the Japanese ones. The latter, however, are more exposed than the former to suffer the negative repercussions of financial crisis, as a result of their close economic and financial connections with the companies.

5. *The blind faith of many economists in the efficiency of financial markets plaid a determining role in the appearance of the housing market bubble*. Indeed, the belief in the efficient market hypothesis proposed by *Eugène Fame* (*University of Chicago*) and *Michael C Jensen* (*Harvard Businesses School*), proved to be false. According to it, financial markets always value the price of assets at their intrinsic true value, at the condition that the whole information is publicly available. Such an ideology prevented them to realise that prices of assets had little to do with the fundamental situation in the real world, but rather with the price of other assets.

6. *The crisis represents the ideological defeat of the school of Chicago*. In my view, this school defends an ideological and illustrated vision of macroeconomics, that of the new economy that promised the end of the economic cycles. Also many neokeynesian economists have continued to think that investors and markets were rational and that, in general, they have worked correctly. Only a few of them rejected the rational behaviour as a paradigm of economic behaviour[3]. The so-called *economic rationality*, however, can be tackled, in accordance with *Amartya Sen*[4]*,* from at least two perspectives. The first identifies rationality with *internal consistency* in the election. The second view makes rationality equivalent to the *maximisation of the self-interest*. In the end, economic thought is anything else but a prolongation of formal logics.

   According to the first perspective, the conventional economic theory understands that economic behaviour is a rational one when it assures *internal consistency* between clear formulations of the aims to be reached –profit maximisation in the production activity, maximisation of utility in consumption, perpetual accumulation in general, etc.– and the rigorous and efficient choice of resources needed to reach them. Ernst *Gellner*[5] reminds us that, among the latter, one can find human beings and human work, treated as goods. The latter considers human work as a simple instrument and casts serious doubts on the fairness to label as *rational* such a perspective of *economic rationality*.

   The second perspective associates economic rationality with *external consistency* in the choice concerning production, consumption, etc., that a person makes following her self-interest. This vision contains a complete rejection of ethics, because any behaviour engaged in interests different from the own ones is labelled as being *irrational*. This purely egoistic behaviour is still the rule in the formulations of many economists. Nevertheless, whether pure selfishness is the exclusive determining factor of economic behaviour, or there are additional, and more philanthropic, motivations that move economic action is still an issue open to debate.

3. The market, the *invisible hand* and the ultraliberal *laissez-faire*

The fail of *Lehman Brothers* and the subsequent pre-collapse of the world financial system are equivalent to the fall of the Berlin wall for soviet communism. The collapse of the communist ideology gave a free way to an upsurge of the utopian ideology of free market fundamentalism and ultraliberal *laissez-faire*. Although the economic collapse derived from the Great Recession does not constitute in itself the end of capitalism, in my opinion, such a situation confirms the

[3] Schneider, Stefan (2010): Homo economicus – or more like Homer Simpson? Deutsche Bank Research, Frankfurt am Main, July 29, 25 pp.
[4] Sen Amartya (2008): Sobre ética y economía. Alianza, Madrid, pp. 30-39.
[5] Gellner, Ernst (2005): Razón y cultura. Síntesis, Madrid, pp. 185-192.

failure of the *laissez-faire* ideology which fed the economic thought of financial *gurus*. They pledged for a complete and unbounded US style in financial deregulation since the mid-1980s. There is also some parallelism with the 11-S, when the end of the US leadership has begun. Beyond the financial crisis, I believe that the current situation reflects a loss of US economic and political leadership since the US economy is so weak that it is unable to keep for a long time, the current spending path which stems from its military hegemony.

Given the role that financial *gurus* attributed to fully free markets, we should ask ourselves what is a market. On these matters, my Director of Monetary Affairs at the European Commission used to tell me: "¿The market? ¿Do you ask me about the market? ¿have you ever had lunch with him?" This reaction was quite logical because, by nature, human beings approach the world with a taste for anthropomorphism, that is, perceive the world with an anthropomorphic and mythical view, as *Miguel de Unamuno* reminds us. Furthermore, there is a misleading identification between capitalism and free market that needs to be clarified. While capitalism basically consists in defending private property, the market is the logical complement of that property structure, but should not be confused with it. The market is engaged in adjusting a high number of independent decisions taken by producers and consumers. This is presented as the alternative to a plan previously determined by both bureaucrats and politicians.

There are certainly many ways of being a liberal. Political liberalism starts with *John Locke*, *Jeremy Bentham*, *Bernard of Mandeville* and *James Mill*, philosopher and utilitarian economist. The latter, together with *Bentham*, was one of the leaders of the movement of the radical philosophers. In the field of economics, this movement connected more recently with authors like *Friedrich August von Hayek* –disciple of both *Friedrich von Wieser* and *Ludwig von Mises*–, and *Milton Friedman* defender of the free market, and an exponent of the neoclassical monetarism of the school of Chicago. This radical economic liberalism, finds its philosophical roots in utilitarism which claims that private vice has positive consequences on the public field. This school of thought has pervaded, and continues to pervade, the mainstream of thought of economists. According with them, the best action on the economy a government can take consists in applying a "hands off" policy. Otherwise, such an action whether by means of tax policies or market regulation policies, for instance, will distort the price formation process. Also, when a government implements counter-cyclical policies, it will amplify even further the economic business-cycle. The proposal of radical liberals is rather simple, and consists in leaving the economy to follow a self-regulatory path and to be driven, as if by an *invisible hand*, to do its work and adjust spontaneously the economy. To put it in *Adam Smith's* words: "[…] led by an invisible hand to promote an end which was no part of his intention"[6]. This school of thought believes that markets are submitted to spontaneous movements of society that alter the relative force of the market participants, markets simply process all these changes and reflect them in a purely impersonal, mechanical and anonymous way, but have its own strength which needs channelling at all.

In my view, this radical vision of economics reflects only partly the *invisible hand* metaphor of *Adam Smith*, as these economists belief that any regulatory action taken by the government is ominous, as it introduces new distortions in the economy which make it less efficient. However, for the greater misfortune of these radical liberal economists, the allegory of the *invisible hand* is only mentioned at three occasions in the whole writings of *Adam Smith*[7]. In *History of the Astronomy* the reference to the *invisible hand* is made in an ironical way. Smith opposes the view

[6] Smith, Adam (1994): <u>An inquiry into the nature and causes of the wealth of nations</u>. The Modern Library, New York, p. 485.
[7] Alcón Yustas, Mª. Fuencisla (1994): <u>El pensamiento político y jurídico de Adam Smith. La idea de orden en el ámbito humano</u>. Universidad Pontificia de Comillas, Madrid, pp. 353-361, y pp. 75-81.

that an *invisible hand* of Jupiter might be the cause of unexpected natural events as thunders or lightning. Moreover, for *Adam Smith* the natural law that governs human action in the field of economics is clearly oriented to make men reach happiness and prosperity. In *Adam Smith*, the idea of *natural order* is part of his vision of a provident God. As a result, the concept of *natural freedom* takes place when *the intention of nature* is able to ensure such an order as the one established by the plans of God who, in turn, is aiming at guaranteeing happiness in every of his creatures.

This idea of *natural order* will be, however, very annoying for radical liberal economists as *Hayek*. Among other reasons, because they rejected the existence of any order previously established by some mind, because it would not only limit freedom, but it would cancel it in full. To escape from *Smith's* views of natural order, *Hayek* introduces the distinction between *taxis*, that is, an order that stems from a deliberate intention; and, *kosmos*, that stems from spontaneous forces. However, the thought of *Adam Smith* escapes to this distinction, as he always talked about an order deliberately set up by God, not by a human mind. This order was subject to the intentions of God and conducted by the divine wisdom. The *natural order* of *Adam Smith* was a regulated one, which established *natural* guidelines that men should follow to reach happiness and progress. At the same time, however, it allowed for freedom as *Smith's natural order* restricted itself to set up the framework for human action to avoid excesses and misbehaviour, because the rules governing such an order were aimed at guiding human behaviour, not at determining it.

In my view, this concept of *natural order* in economics relates with the idea of divine providence which, according to *St. Thomas Aquinas*[8], "imposes necessity to some things, thought not all [as its effects] does not consist in making something to happen in any way; but in making it to happen in a contingent or necessary manner […] the order of the divine providence consists in that what has been provided by God does happen as He has determined, that is, in a contingent or necessary manner". Therefore, in my opinion, the famous *invisible hand* of *Adam Smith* is a secular version of the divine providence, which was theologically developed by the medieval scholastics and, most particularly, by *St. Thomas Aquinas*, for whom it was necessary for God to be provident –an attribute which falls within the field of understanding and volition– because all things over this world have been created by God, and they find the good to the extent that all these things are guided towards a final aim which is God goodness. Therefore, it is not surprising that the political liberalism of *Adam Smith*, as well as the benevolent utilitarism of *David Hume,* and the humanitarian liberalism of *John Stuart Mill* –half kantian and half utilitarian, heavily influenced by the romanticism, and a revisionist of the radical utilitarism of *Bentham*– may find some of their important roots in the medieval scholasticism. This could also explain why a liberal, this time a Spanish one, *Miguel de Unamuno*, had once stated that "liberalism is, above all, a theology"[9].

Other enlightened philosophers, such as *Immanuel Kant*, will also be attracted by the idea of a *natural order* governed by ideas very close to that of the *invisible hand* of *Adam Smith*. In this case, the expression *own interest (Smith)* has been transformed by *own intention (Kant)*, and the famous *invisible hand (Smith)* has become *the hidden intention of Nature*: "Men can hardly imagine that, by pursuing each of them their own intention, in accordance with their opinion, and

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[8] Sanctus Thomae Aquinatis (1952): <u>Summa Theologiae</u>. Marietti, Roma, Pars Prima et Prima Secundae, Quaestio XXII, De Providentia Dei, pp. 128. Edición en español, Santo Tomás de Aquino (2006): <u>Suma Teológica</u>. Biblioteca de Autores Cristianos, Madrid, Parte Primera, Cuestión 22, Sobre la Providencia de Dios, p. 273.

[9] Marichal, Juan (1995): <u>El secreto de España. Ensayos de historia intelectual y política</u>. Taurus, Madrid, p. 101.

most often against others, they follow without noticing it –as a main theme– the intention of Nature, which is completely unknown for them, and work for the latter, being so that, had they known it they would care really little"[10]. Men aim at materialising both the *hidden intention of Nature* and the fatality of a secular order of the world *as if* another god, this time different from the scholastic one, had a predetermined plan which had arranged everything, and on which men had no control at all.

In *Kant*, this new order is the *cultural order*. The consideration of man as an aim in itself, is based on his rational nature and, in this sense, what *Kant* names *the hidden intention of the Nature* consists in anything else but the subversion of this natural order, that is, in the overcoming of the deterministic (cause–effect) natural order, and in the production of a completely rational new order. In moral terms, it would mean moving from the dominion of the *heteronomy* – which relates to the necessary adjustments of all objects of the nature to natural laws that they have not given themselves, external laws– to the order of the autonomy, that is, the order which obliges to comply with norms and laws that human beings have conceived and given to themselves, in order to organise their lives within a framework of intersubjectivity, or social framework.

On the other hand, *Kant* has a pessimistic vision of men as he considers that "[…] all and each of them will always abuse of their freedom, if they do not have above themselves anybody who exercises the power in accordance with laws [because] from such a twisted wood on which the man is made, nothing can be carved completely right"[11]. This is the way in which Nature wants humanity to achieve by itself its own end, namely, the development of all their natural aptitudes: "The necessity which constraints men –who are so much passionate by freedom without ties– to accept this state of coercion, is really the greatest, that is, the one which they inflict each other, whose inclinations lasting for a long time is wild freedom. Only in the field of civil association those inclinations will produce the best result: the same way as the trees experience in the middle of the forest a beautiful and straight growth, just because every tree tries to deprive each other the air and the sun, obliging mutually themselves to look for both things above themselves, instead of growing atrophied, twisted and bent"[12].

As we see, *Kant* believes in freedom as well as in the benefits that society can obtain from free competition among men. In the field of microeconomics, this matter might constitute a good philosophical basis to understand the efficient performance in competitive markets. However, and unlike radical liberalism, *Kant* determines and restricts freedom to the compliance with law, well-informed as he was, that men were made of a twisted wood: "[…] the issue at stake is not the moral improvement of men, but rather the mechanism of nature; the problem lies knowing how can be used this mechanism in men to arrange the opposition of their non peaceful instincts among people, in such a way that they could oblige each other to give way to coercive laws and, in that way, generate a situation of peace in which laws are in force"[13].

We have seen so far how mainstream economics remains anchored in the fundamental principles of the radical utilitarism, namely among economists of the school of Chicago. We have also seen the large differences which exist between different approaches to freedom, the market, and the metaphor of *invisible hand*. Over the last 30 years, however, the use of these radical liberal principles has become a hollow ideology. This fact is at the very root of the current financial crisis and explains how this school of economic thought is still anchored in a very distant

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[10] Kant, Immanuel (2006): Ideas para una historia universal en clave cosmopolita. Tecnos, Madrid, p. 4.
[11] Kant, Immanuel (2006), *Op. cit.*, p. 12.
[12] Kant, Immanuel (2006), *Op. cit.*, p. 11.
[13] Kant, Immanuel (1994[4]): Sobre la paz perpetua. Tecnos, Madrid, p. 39.

philosophical universe –from the XVIII and XIX the centuries– in which commercial capitalism paved the way for the emergence of the incipient financial capitalism, and neither the corporate managerial capitalism nor the global financial one was yet at sight.

Until the global financial crisis, the philosophical foundations of mainstream economics has been based on radical utilitarian liberals, together with a greater taste for formal theory whose models are mathematics and logic, instead of empirical sciences models. These economists have overemphasised abstract models, and identified the hypothesis of rational economic behaviour with a strict utilitarian, chrematistic and self-fish behaviour. They claimed a complete market deregulation to allow for an unbounded freedom to the economic market agents. Instead, I believe that it is a mistake to approach the economic reality nowadays with the old-fashion views of the age of Enlightenment. Moreover, the economy is not only guided by fully rational actors who are driven, as if by an *invisible hand*, to undertake activities aimed at obtaining only and exclusively the maximum individual profit, and at satisfying their own self-interest. There are also many other activities which are not governed by a behaviour reflecting a utilitarian rationality, but by stimuli that move people and are not always chrematistic in nature.

To sum up, in an economic system there are many different types of markets, and not all of them should have to be regulated with the same intensity. Markets that work with greater stability should be submitted to a lesser regulation, while more unstable ones would be more severely regulated. In my view, the current debate should not focus on the contrast between market and State, as sometimes the *ultraliberal neocons* pretend, but rather between regulated market and fully regulated, fully free market. Perhaps a less *cyclopic* and more *macroscopic* approach to economics would help explain how the economies work or, for example, why *animal spirits* are the main cause of economic fluctuations.

4. How the European Union has reacted

To face both the increase in risk aversion and the collapse of capital flows, central banks reacted, one after another, adopting unconventional measures. By mid-March 2009, the *Fed* has changed its strategy and has begun to buy mortgage assets, commercial paper and public debt, in order to inject new money into the system and to stimulate investment in the stock exchange. In March 2009, the *Bank of England* applied also non conventional monetary measures and printed money to buy *Gilts*, that is, government bonds.

Regarding the *European Central Bank*, it had already indicated its readiness to implement *quantitative easing* whenever it considered necessary. At the beginning of May 2009, it has announced the adoption of *non conventional measures*, and was ready to use the printing money machine, as well as other measures such as: (i) reduction of the intervention rate to 1%; (ii) extension to 12 months of the maturity period of credits at fixed rate to European banks; and, (iii) purchase of mortgage certificates (assets), that is, titles endorsed by mortgages, by an amount of €60.000 mn. in the secondary market. The latter implies an enlargement of the monetary liabilities side of the balance-sheet of the ECB, that is, of base money or high-powered money. However, the ECB did not give much details on how this operation was to be implemented, neither about the institutions which were supposed to sell the mortgage certificates, which countries –Germany, France and Spain amounted to about 20% of the eurozone–, or which type of paper the ECB would be ready to accept, etc.

European governments have also been very proactive and have given an answer to the financial crisis in three different areas. In the first place, they have recapitalised financial institutions; secondly, they applied fiscal stimulus programmes; and, finally, they granted aid to some sectors of the real economy. *In the financial sector*, they gave public guarantees to the banks, in some cases they have recapitalised them, while in others they have implemented some nationalisations. *In the households and companies sectors*, governments have introduced fiscal measures, of a discretionary nature, aimed at supporting households; unemployed people was helped through higher spending measures to support them; and, support to companies has materialised by means of an increase in investment expenditure. Finally, *in the real economy*, governments have taken measures aimed at improving the functioning of the labour market, at investing in energy efficiency, as well as in R+D and infrastructures, and of strategic business sectors such as the automobile, tourism and construction.

The European Commission, in turn, set up a European strategy to safeguard financial stability. On October 29th, 2008, President *Barroso* made a public speech entitled *From financial crisis to recovery: A European framework for action*[14]. On November 26th, 2008, the Commission launched the *European Plan for Economic Recovery*[15]. Finally, on February 25th, 2009, the final report of the *High Level Expert Group on EU Financial Supervision* chaired by *Jacques de Larosière*, set up the basis to consolidate co-ordination and cooperation of the different national supervisors through the creation of new European agencies whose authorities were to supervise the risks of the European financial system as a whole. In May 27th, 2009, a Communication from the Commission on *European Financial Supervision*[16] aimed at safeguarding European financial stability. It constitutes the cornerstone for the construction of an action plan aimed at reforming the regulation and supervision methods of financial markets in the European Union. The Communication anticipated also legislative changes that came into operation in the autumn of 2009.

Other measures on financial institutions, included a higher control of alternative investment funds, including *hedge funds*, and recommendations about greater containment of the remunerations of financial executive managers. On September 7th, 2010, the ECOFIN approved a package of reforms on the financial regulatory framework. It will come into force by 1st January, 2011, and includes three new European regulatory bodies for banks, insurances, and stock exchanges, together with another authority on systemic risks. Therefore, at present, the new regulatory framework to safeguard European financial stability is organised around two pillars:

(i) *The European Council of Systemic Risk (ECSR*) which aims at a macro prudential supervision. It is entrusted to watch and assess systemic risk threats which may appear in the macro-economic front, as well as those of the financial system as a whole. An early warning system is made up to this aim. It will formulate alert signals and will send recommendations for action to both the *Ecofin* and the *European Financial Supervisory Authorities*. It is aimed at correcting the vulnerability of the financial system in view of the interconnected, complex, sectoral, and inter-sectoral nature of systemic risks; and,

(ii) *The European System of Financial Supervisors (ESFS)* which is entrusted of the micro prudential harmonisation, that is, to establish a national financial supervisor network that work closely with the new *European Financial Supervisory Authorities*. It is aimed at both safeguarding financial soundness at the level of each individual financial organisation, and protecting consumers of financial services. This network combines the supervision of organisations in the national area, with the centralisation of specific tasks in the European filed, in order to strengthen the harmonised rules, and to make supervision and implementation coherently. All the above aims at strengthening confidence among national

[14] SPEECH/08/566.
[15] COM(2008), 800 final.
[16] COM(2009), 252 final.

supervisors, and to make sure that the voices of *guest supervisors* are appropriately listened when formulating the supervisory policies regarding financial stability and consumer's protection, to face risks among countries in the most effective way.

5. From a financial to a debt crisis: the weaknesses of the euro at sight

Measures undertaken by the European governments and the European Union to face the Great Recession have made escalate public deficit figures. In an environment of economic recession, the accumulation of deficits has generated a dynamic that boosted the debt/GDP ratio, a feature which has not been unnoticed for international investors. Banking and financial crises are almost always followed by sovereign debt crisis. Furthermore, in the case of the European Union, this deficit and debt crisis –on the other hand, unavoidable to escape from the complete collapse of the global economic and financial system– happened within the framework of fiscal rules whose economic rationale is today partially open to debate.

It is important to recall that the entry of a country into the euro area implies loosing control on both monetary and exchange rate policies for macroeconomic stabilisation purposes. This lets any government with fiscal policy as the only available tool to face macroeconomic asymmetric shocks. Therefore, when a eurozone country is negatively affected by a shock, *good economics* advises the use fiscal policy in a flexible manner, that is, to leave increase public deficit and allow automatic stabilizers to play freely. A greater need of indebtedness –provided capital markets are efficient and frictionless, and governments might accumulate public deficits without having to face neither solvency nor fiscal policy sustainability problems– might be financed by those countries of the area which have savings. However, the payment of debt-servicing reduces the margin of manoeuvre of the country negatively affected by the shock; and this happens at the very moment when the country needs adjust to the shock in a flexible and this requires a wider margin for manoeuvre of its fiscal policy. Moreover, the rapid accumulation of deficit publics and debt puts upward pressure on real (inflation adjusted *ex post*) long term interest rates. The latter constitutes a deadweight-loss for growth and would set the debt/PIB ratio into an explosive path of unbounded growth, putting the financial sustainability of the country under the spot light.

According to economic literature a monetary area requires the introduction of fiscal rules; otherwise there would be negative externalities from the less virtuous countries of the area to the most virtuous ones. Unsound financial policies would put heavy pressure on interest rates and, thus, it would increase interest payments of other area members obliging them to adopt more restrictive fiscal policies than otherwise, to face such a high interest payments. Moreover, an expansionary fiscal policy would interfere with monetary policy, since the European Central Bank would be more bounded not to tighten its monetary policy and would resist, for instance, raising the intervention rate. These arguments, however, have been criticised because its underlying assumption is that capital markets are inefficient because they are unable to allocate different *risk premia* to public debt of each area member according to the specific situation of its public finances. Negative externalities would not take place if capital markets worked efficiently and were frictionless.

Despite the previous, it is possible that financial markets, when assigning *risk premia* to those countries with less sound public finances took into account the impact that a declaration of bankruptcy might have on other area members. To avoid this threat, the Treaty introduced in article 104B the prohibition for the Community or Member States to assume or respond on commitments of another Member State. However, without the setting up of rigorous fiscal rules concerning the size of the deficit allowed within the union, the problem of credibility in implementing this clause would continue to be open. Therefore, and in view of the difficulties to apply those rules, the Treaty replaced this idea by the *Excessive Deficit Procedure* (*EDP*) in article 104C, according to which, recommendations to Member States are formulated to make its public finances comply with the Maastricht criteria.

All these cautions have not prevented on April 23th, 2010, the Greek economy minister, George Papaconstantinou, to request the activation of the aid mechanism in accordance with the declaration of the Heads of State and Government of March 25th, which permitted giving financial aid to Greece when necessary. Some weeks later, the Greek crisis contaminated very negatively economies such as the Spanish one, and put the eurozone on the brink of the precipice. In early May 2010, it brought about the implementation of a rescue package. In a few months, the eurozone's economic authorities shifted from speaking of an aid of €30.000 mn., to an aid programme for Greece amounting to €110.000 mn., together with the setting-up of a *European Stabilisation Fund* by an amount €750.000 mn.

Leaving aside the problems concerning the reliability of deficit and debt figures[17] reported to the European Commission which are used in the elaboration of the *Excessive Deficit Procedure* (*EDP*), the European authorities were confronted the following dilemma:

(i) either to intervene financially to rescue Greece, something which would allow the functioning of *moral hazard* and, therefore, feeding financial misbehaviour of other area members in the future; the latter would imply that, in the future, those member countries would have no incentive to act in a responsible way as the *Stability and Growth Pact* requires, and would put the economic rationale of *SGP* in jeopardy; or,

(ii) do not intervene to rescue Greece, allow the default of Greece, pave the way for a contagion effect on other eurozone countries, like Spain, and cast serious doubts on the viability of the euro.

The setting-up of the *European Stabilisation Fund* to provide financial support for countries having difficulties arising from external conditions which escape from its control, is probably one of the most risky political decisions ever taken by the *European Union* in many years. In spite of some initial parsimony to create it, financial markets pressures have precipitated a speedy set up during the weekend of May 8-9. The agreed total amount was of €750.000 mn., which is broken down into two parts. On the one hand, €500.000 mn., of which €60.000 mn. will be provided by the *European Commission*. The remaining €440.000 mn. will be provided by Member States through the setting-up of a financial instrument –the *Special Vehicle Purpose* (SPV)– which is guaranteed *pro rata* by Member States with a three-year maturity. On the other hand, an additional contribution by the IMF amounting to €250.000 mn., and with a strong conditionality following the IMF style of aid programmes. Finally, the *European Central Bank* announced measures that only a few days before it had claimed would never take: the *ECB* agreed on a new *Securities Market Programme* to buy sovereign and private debt in the eurozone, extended the liquidity programmes, and renewed them up to January 2011 *temporary swaps agreements* in dollars with other central banks. The monetary virginity of the ECB was gone.

The close perspective of collapse of the single currency project took over political vetoes and helped removing legal obstacles in the interpretation of the Treaty. The special European summit in May recalled Article 122.2 of the Lisbon Treaty which allows the Council, following the proposal by the Commission, to decide, under certain conditions, financial aid of the Union for a Member State that is in difficulties or risk of serious difficulties caused by natural disasters or

[17] On the relevance of this issue see Gordo Mora, Luís; Nogueira Martins, Joao (2007): "How reliable are the statistics for the Stability and Growth Pact? Mimeo, 40 pp.

exceptional events that the aforementioned State might not control. However, they forgot continue reading, because after Article 122.2 it follows Article 123, which clearly states that it is unlawful the authorisation of overdrafts or the concession of any other type of credits by the *European Central Bank* and the central banks of Member States, in favour of institutions, bodies or organisations of the Union, central, regional or local Governments of Member States, as well as the direct acquisition of its debt instruments by the *European Central Bank* or by national central banks.

The conclusion which we can draw is quite clear. On the one hand, the amount of €750.000 mn. might be suitable for Greece or Portugal, but perhaps is not enough for other medium-size countries such as Italy or Spain. With respect to the instrument used, the so-called *Special Vehicle Purpose*, it is morally doubtful to use it now when, a few weeks before, the European Union had announced its intention of prohibiting it in the future. On the other hand, financial markets, put heavy pressure on the European economic authorities to double check its determination to continue pushing for the European integration project. In doing so, financial markets have become the most prominent factors over the last years in getting real progress in European economic integration, something that politicians have failed to promote. ¿Shall we continue to leave the Europe's federalisation in hands of financial markets, or rather, have we to regain this project for the field of politics?

6. The way ahead

Capitalism failed to transform private vices such as egoism, greed and lack of solidarity, into public efficiency and progress. Moreover, some of the main actors, as banks and rating agencies, have betrayed the most elementary ethical foundations of capitalism as, for instance, the Calvinistic work ethics, the taste for a well done job, the fairness between effort and reward, the sacrifice of saving and the corresponding compensation in interest payments and greater future consumption. Macroeconomics claims labour remuneration, as expressed in real wages, has to be in line with productivity increases. But, contrary to the previous, large corporations agree to set top executive managers remunerations at astronomical levels, irrespective on whether or not the companies which they manage obtain profits. It would be suitable for our political authorities to indicate the type of specific measures needed to recover the ethical pillars of capitalism and regain part of its ethical legitimacy which is completely forgone right now. Of course, we are referring to proposals that have a practical and real effectiveness, and are not diverted, once more, by the agreements and pacts made in the shadow by large oligopolistic corporations and its top executives.

On a general level, we need to revise the Bretton Woods institutions, as well as globalisation of world trade and financial markets, and reform the world financial architecture. We also need a global financial system with a global monetary reserve, and decide the function that banks have to develop in our society. We also need a revision of the role that *rating agencies* play, because there are only two large and both are Americans (*Standard&Poor' s* and *Moddy's*). This creates a quasi-monopoly and introduces a qualifying bias in towards the American economy which could help partly explain why these agencies have always failed in preventing economic crisis as those of 1980's, or the technological crisis of the *dot.com* of year 2000.

On a European level, the first spontaneous reaction consists in asking for greater economic integration and revisiting the Delors Report of June 1989, in which it is stated that "Wage flexibility and labour mobility are necessary to eliminate differences in competitiveness in different regions and countries of the Community. Otherwise, there could be relatively large declines in output and employment in areas with lower productivity. In order to reduce adjustment burdens temporarily, it might be necessary in certain circumstances to provide financial flows through official channels."[18]

On the other hand, the proposal to create a genuinely European *rating agency* has to be welcomed, it arrives too late tough. In spite of the constant recommendations made for years by some civil servants of the European Commission –always ignored by the hierarchy– in favour of the creation of these agencies, it is difficult to understand the following: (i) Europe is the greater world saver block, however, it has to pass through the control of the US *rating agencies*, to unable the EU countries to issue paper on international capital markets; and, (ii) some EU countries like Italy are in hands of the US *rating agencies*, because they can prevent Italy, or any other EU country, from obtaining the required international funding in case the *rating agencies* rate the country below the AAA level, the reason being that large American investment funds are not allowed by statutory orders to subscribe paper issued below this quality level.

The European Union has launched the new *Agenda 2020*. The reform of the *Stability and Growth Pact* has also begun, and the possibility to consider not only public debt, but also private sector debt has been announced, together with the need to survey the change in unit labour costs. New financial regulations have been proposed and, among them, new financial supervisors. On September 7th, 2010, the *Ecofin* ratified an agreement which will be endorsed by the European Parliament by the end of September. The agreement contains a package of reforms on the financial regulatory framework which is expected to come into force by 1st January, 2011. It includes the set up of three new European authorities to supervise the financial activities of banks, insurances, and stock exchanges; and, finally, a forth authority the *European Council of Systemic Risk (ECSR*), in charged of preventing financial risks such as the formation of speculative bubbles in the housing markets. Although the ordinary supervision will remain in national hands, the European authorities will be able to intervene directly in banks, insurances companies and stock exchanges in an emergency situation. The broad lines of reform are aimed at establishing common rules and strong authorities, to prohibit highly risky and dangerous financial products, to protect the consumer and to reinforce guarantee funds. It will be of utmost importance for the newly stipulated supervisory mechanisms to be exempted of any possible defaults. On the other hand, limits on the *bonuses* of the financial directors are also needed, namely when there is no correspondence with poor results obtained by the companies or financial institutions.

The *European Union* also plans the introduction of a tax on banks which might be materialised as a contribution to the *Deposits Guarantee Fund* of each Member State. Moreover, *stress tests* for banks have been made to help recover confidence. This constitutes a good practice of transparency and should be repeated with certain regularity. Also, a directive on *hedge funds* has also been established, and there is a proposal to limit some of the most speculative stock-market operations.

From a macroeconomic perspective, at has to be added that we need of a *European Stabilisation Fund* of a greater amount than the one established in May, as well as greater co-ordination of fiscal policies among Member States. Furthermore, since the budgetary neutrality of the European policies remains a myth, we need to take a qualitative jump in the size of the EU budget. We need a budget of the minimum size as for the ECOFIN to use it as a counter-cyclical economic policy tool. This brings us on the need to introduce a new European tax to increase the EU own resources in spite of the reluctance of Germans and French who are still willing to reduce its respective contributions.

[18] Committee for the Study of the Economic and Monetary Union (1989): Report on economic and monetary union in the European Community. Madrid, June, p. 19.