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EXPLAINING THE "SUBPRIME" CRISIS: WHY IT HAPPENED, HOW IT DEVELOPED AND WHERE WE GO FROM HERE

The UK's flawed deposit insurance system was the key factor that failed to prevent the debacle of a run on Northern Rock. Alan Greenspan, one of the most highly-regarded chairmen of the US Federal Reserve, may have sown the seeds of the subprime crisis. And Central Banks should raise interest rates to prevent bubbles developing in housing markets.

These are some of the conclusions of leading economists published in a new book, 'The First Global Financial Crisis of the 21st Century', which analyses the ongoing turmoil in global financial markets that began in 2007: why it happened, how it developed, and what can be done.

The book is a collection of articles that have appeared on VoxEU.org, the website for research-based analysis and commentary from leading economists. Vox, which celebrated its first birthday in June 2008, was set up to give expert analysis of contemporary economic events delivered in an accessible way.

Professor Carmen Reinhart, co-editor, comments:

'We have learned a lot from the causes and consequences of what brings about these financial crises, but the fact is we are only at the tip of the iceberg. Our interest in crises is not academic - it is what we live with day-to-day and what we are likely to live with day-to-day in the months ahead.'

The book is organised into three sections:

Why did it happen?

The book examines a number of different potential causes of the crisis. One considers whether the seeds of the crisis were sown by Alan Greenspan, former chairman of the US Federal Reserve, as he lowered US interest rates to 1% following the 'tech bust' of 2000-1. A second set of articles considers whether the regulators failed. The consensus is that new financial techniques, not properly understood by investors nor regulators, contributed to the crisis.

Stephen Cecchetti argues that policy mistakes were not to blame for the subprime crisis. Crises are an inevitable part of modern economies, he argues. But policy failures can make crises worse or more likely. In particular he argues that the UK's system of deposit insurance is badly flawed: if it had worked as it was supposed to, it would have prevented the Northern Rock debacle.

How did it develop?

The path of the crisis can be traced through a string of Vox articles written as the crisis was unfolding. Early analysis understated the extent of the problem, with an article of 31 August 2007 predicting an extensive 'but benign' crisis. Quickly, though, it became clear that the extent of the crisis was much more severe than first realised - and articles both written at the time and later clearly explain the path of the crisis.

Dennis Snower explores how the crisis has spread from the US around the world - before highlighting four 'mega-dangers' for the world economy. The final danger - that the Fed may have let inflation and expectations of inflation rise is only now being realised.

What can be done?

The final section of the book assesses a variety of different policy responses to the crisis. Different contributors highlight the need for tougher regulation, especially of credit rating agencies. Some argue that central banks may need to hike interest rates to prevent more asset bubbles forming, such as those in housing markets, which led to this crisis.

Willem Buiter argues that the 'tripartite' arrangement between the Treasury, the Bank of England and the Financial Services Authority failed - especially in the bungled handling of Northern Rock. He also argues that the Bank of England did a worse job than either the US Federal Reserve or the European Central Bank in responding to the crisis.

ENDS

Notes for editors: 'The First Global Financial Crisis of the 21st Century' edited by Andrew Felton and Carmen M. Reinhart is published on Monday 7th July 2008 by the Centre for Economic Policy Research (CEPR). It is available to download free of charge from www.VoxEU.org.

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