Is a new bubble being formed?

By Johnny Munkhammar and Johan Norberg

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Europe may be laying the foundations for the next financial bubble, through its monetary, industrial and regulatory policies.

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In the midst of the worst crisis in half a century, it is easy to forget that the real problem is not the bust but what preceded it: a boom filled with bad investments.

The boom was a natural consequence of too much easy money for too long. That policy was itself a response to the bursting of the dotcom bubble, to which Alan Greenspan and the Federal Reserve responded by cutting interest rates from 6.5% to 1% – and keeping them that low for a whole year. The result was a market drowned in cheap money.

People could buy what they wanted, but, after the dotcom crash, they did not trust stocks or bonds, and so they turned to the safest bet: real estate. People could buy bigger and better without having to pay much; indeed, they could profit more by buying bigger and better. As more money entered the market housing prices in the US increased by 10%-15% per year. The effect was such that, even if you lost your job, you could take a second mortgage, because your primary property had increased in value.

As Alan Greenspan admitted in his memoirs: “We were willing to chance that by cutting rates we might foster a bubble, an inflationary boom of some sort.” In short, the Fed saved us from the dotcom bubble by inflating a new bubble – in housing. To varying degrees, central banks elsewhere followed the Fed's example.

At the same time, successive US governments did everything to promote home-ownership, even for those who could not afford it. Deductions, subsidies, insurances and trillion dollar commitments from government-sponsored companies like Fannie Mae and Freddie Mac undermined underwriting standards. Wall Street then put the whole sub-prime mortgage process on speed by securitising mortgages and so passing them on to someone else.

By the end, too much wealth had ended up in investments that were worth much less than we thought. The banks and financial companies that financed those investments have made gigantic losses.

There now seems to be a consensus that with this crisis as the result of too low interest rates, too much borrowing and too many bad investments. So it is ironic that central banks and governments in Europe are trying to meet the crisis with even lower interest rates, even more borrowing and with attempts to subsidise and protect bad investments and overproduction – in the housing sector, the car industry and everything in between.

Worse than the irony, of course, is the danger that now – just as in 2001 – central banks are responding to one bubble by inflating a new one.

Again, the bubble is being filled with bad investments. A recession is a time when we should sort out bad investments and transfer capital and labour from failed sectors into more competitive industries. Instead, it seems as if European politicians would like to keep failed investments on life support until economic growth makes it possible for them to survive on their own. The result may be a delayed return to healthy economic growth.

Moreover, European leaders appear not to have understood that government failures contributed to the crisis, not just market failures. A failing that the markets and governments shared in was the creation of a monoculture. Banks did so by using the same standards and computer models; governments did so by harmonising regulation.

There was one part of the market that both speculated against the housing bubble and contributed liquidity when the markets froze in the autumn of 2008. That part was made up of hedge funds – and one reason why it bucked the trends was that they did not face the same regulation and capital requirements as others. When regulation failed uniformly everywhere else, this unregulated part of the economy continued working.

And how have the European Commission, the EU, the US and the members of the G20 responded? By proposing strict regulation of hedge funds and making sure that they behave just like everybody else the next time around. Not because hedge funds contributed to the crisis, but only because the proposal has been in the works for a long time.

One virus came close to wiping out the financial system last September. Now our regulators seem determined to remove the last bit of diversity. Danger looms.

Johnny Munkhammar *is the research director at the European Enterprise Institute.* ***Johan Norberg*** *is a senior fellow at the Cato Institute.*