Nobody is perfect: markets can lead to inefficiencies

1. Bdd rationality
2. Bubbles
3. Endogenous instability (Minsky)

Lordman (the problem seen from a regulator)

The mkt is more complete in the Arrow and Debreu way.
The more finance we have the better: more liquidity in financial markets the more efficient the convoy will be.
Also applies in/between countries. Freedom to financial innovation and free movement of capital are the consequences of this approach.

Burden of proof in finance regulation: the regulator must prove beyond any reasonable doubt that a rule is necessary and better than o intervention.

Adair turners conclusion

More innovation is not limitlessly beneficial.

Ceccetthi:

- Again there is a limit of finance as a good.
- Faster growth in finance jobs may not be good for real economy productivity
- Financial booms may negatively affect R&D or other real economy related industries: could be explained because finance jobs are taking the brilliant people from the real sector economy.

Finance is a doubled sided sword.

When does debt becomes too much?

You can only repay debt if your financial surplus is greater than 0.
$S-I=\Delta FA-\Delta FL$
In a steady state economy you don't have increasing resources so lending becomes a problem. Obviously in a growing economy credit is good because it gives you the possibility of expanding capital and therefore create more growth.
Growth is the key link between being able to pay and the sustainability of debt (along with interest rate and public spending surplus/deficit)

- Beyond a certain level debt is bad for growth 85-90% of GDP
- Highly indebted countries should aim to lower and stabilize the debt
- Keep debt below the threshold in case there are unprecedented events that

require borrowing.

Takeaways

- Economic growth and fin dev is linked
- Markets do not crowd out banks: banks go hand in hand with theq mks
- Financial growth can be problematic in quantitative and qualitative inefficiency
- debt now may have negative effects on growth

The five waves of the financial markets

1. Subprime crisis phase

Investment portfolio collapses. Because the easy lending bubble collapses.
RMBS: residential mortgage backed security. ---> first market to suffer was subprime because it was the most vulnerable one.

2. Systemic crisis phase

Lehman brothers collapses.
Liquidity evaporated from one day to another: Liquidity flows IFF there exists trust, but when trust is stopped the flow stops. There's an increment in the conjecture of risk.
massive injections by central banks couldn't take it anymore.
Collaterals were not enough.
--->state aid.

A bank will have an anticyclical behavior: role of the private information: hidden reserves stille reserven.

Lessons from wave 2:
- Liquidity can disappear suddenly
- Svp were providing liquidity but in an inefficient way
- Lending in wholesale is based in collateral?
- Money market mutual funds: broke the buck when the share goes lower than a dollar. Problem was also with the shadow banking system: but is is actually an offspring of the official banking system.

3. Economic crisis phase

Fiscal stimulus and a brief period of calm

4. Sovereign crisis phase

Some members are more indebted than others, and since the EU is not a fiscal union, coordinated policies in this sense are difficult ro implement,But in general 87% of GDP.

In Europe the current account balance is actually 0,Germany works as a leading country in terms of exportation: stabilizing effect.

There could be a metastatic effect from Greece, -->Portugal.

Reasons for not letting Greece fail:

- It's economy is relatively small
- Exit from the Euro is prohibited, otherwise the treaty would be weak
- Restructuring the Greek debt
    - First aid may 2010
    - 750€ in summer 2010
    - Also Ireland and Portugal asked for money

Costs of the euro lack of confidence:

- Collateral based on gov bonds imposed significant costs on the European banks.
- --> lack of trust in banks
- In order to solve this there were injections of capital, but this recapitalization was not actually felts for small and medium european banks.

2011:more and more liquidity problems.

EBA: European banking authority

Solutions: exceptional injection of liquidity (1trillion€), fiscal compact and stabilization mechanism

5. Crisis of confidence in Europe phase

We're still in this phase.

Primary difficit: debt before interest rate.

GDP expected is higher than actual GDP growth: are we underestimating fiscal multipliers?

Takeaways

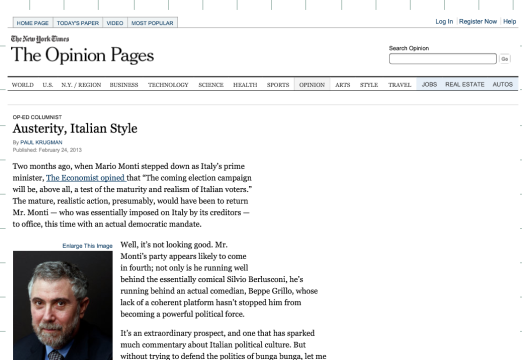
- The financial crisis is a complex and spreading phenomenon

Level of debt

HH: household
GG: government
NFC: non financial corporation

in Europe the growth of the banking system reflects the growth of the non financial sector.
Total bank sector is larger in EU than US and Japan.
UK is a particular case, GDP over size of banking may be a proxy for negative externalities.

Austerity: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Austerity, Italian Style

By PAUL KRUGMAN
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Two months ago, when Mario Monti stepped down as Italy's prime minister, The Economist opined that "The coming election campaign will be, above all, a test of the maturity and realism of Italian voters." The mature, realistic action, presumably, would have been to return Mr. Monti — who was essentially imposed on Italy by its creditors — to office, this time with an actual democratic mandate.

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Well, it's not looking good. Mr. Monti's party appears likely to come in fourth; not only is he running well behind the essentially comical Silvio Berlusconi, he's running behind an actual comedian, Beppe Grillo, whose lack of a coherent platform hasn't stopped him from becoming a powerful political force.

It's an extraordinary prospect, and one that has sparked much commentary about Italian political culture. But without trying to defend the politics of bunga bunga, let me