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Financial Markets and the Global Debt Crisis: Toward a New Architecture for A More Reliable Financial Sector*

Hans-Georg Petersen**
Alexander Martin Wiegelmann***

Abstract

The breakdown of the financial markets in 2007 and the ensuing debt crisis in the EU has produced enormous mistrust in financial products and the monetary system. The emergence of shadow banking also changed the behavior patterns of management so that its self-interest dominated the interests of shareholders and the other stakeholders. These false incentives led to merger processes in the financial system resulting in market structures in which single institutions became too big or too connected to fail. The empirical developments and the political counter-measures described in this article point to the fact that the macro-perspective has been dominant, neglecting individual irresponsibility and failure.

Key words: capital funding, corporate social responsibility, financial markets, principal agent problems, risk management

Resumen

La caída de los mercados financieros en 2007 y la subsecuente crisis de la deuda en Estados Unidos produjeron una enorme desconfianza en los productos financieros y en el sistema monetario. El surgimiento del sector bancario en la sombra (*shadow banking*), también ha cambiado los patrones de conducta de la administración, de manera tal que los intereses de esta última dominaron los de los accionistas y otros tenedores de acciones. Estos falsos incentivos llevaron a fusionar procesos en el sistema financiero que tuvieron como resultado el surgimiento de estructuras mercantiles por medio de las cuales cada institución por separado se hizo demasiado grande o demasiado cercana al fracaso. Los desarrollos empíricos y las contramedidas políticas descritos en este artículo apuntan hacia el hecho de que ha dominado la perspectiva macro, lo que de algún modo niega la irresponsabilidad y el fracaso individuales.

Palabras clave: Fondeo de capital, responsabilidad social corporativa, mercados financieros, problemas del agente principal, administración de riesgos

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** Faculty of Economics and Social Science, University of Potsdam, Tax and Transfer Research Group, Berlin, hg@profpetersen.de

*** Faculty of Economics and Social Science, University of Potsdam, Tax and Transfer Research Group, Berlin, alex.wiegelmann@gmail.com

Introduction

The financial system, consisting of financial markets, banks, and insurance firms, has always been heavily dependent on its clients' confidence in the sustainability of the financial products it provides. Hence, financial products have often been characterized as credence goods where "the sellers act as experts determining the customers' requirements" (Emons, 1997). The functional capability of such markets is only preserved if the sellers in a mid- and long-term ensure the quality of the products supplied and are able to overcome the temptation to exploit the existing information asymmetry in their short-term interests to maximize their own income and wealth. The concept of corporate social responsibility (CSR), developed in a long process of professional experience, has delivered a value base for intrinsic motivation, which has been a certain guarantee for consumer protection. If mutual trust is eroded more and more by a growing number of unsound sellers, financial markets become inoperable.

The emergence of the unregulated shadow banking system (Stein, 2010) and the subprime credit crisis (Diamond and Rajan, 2009; Mishkin, 2011) have often been mentioned as the most important causes for the global financial crisis. Therefore, especially macro-prudential approaches to financial regulation have been proposed (Hanson, Kashyap, and Stein, 2011). But as significant as the macro-perspective might be, individual misbehavior of market agents is another important fact: the vastly increasing number of market-based financial institutions has required the engagement of a large staff that is obviously quite differently motivated and much more extrinsically oriented than their peers at conventional banks, who are subject to higher risks to their reputations. Sellers' interests in the form of high salaries and bonuses became dominant, and this behavior has also infected the staff's behavior within the conventional banking system. Not only have the Basel accords, government supervision, and regulation alone failed to work but the self-regulation through CSR totally collapsed. The long-term functioning of financial markets has been sacrificed for the sake of short-term selfish interests of management and staff.

Apart from the predominately macro-orientated mainstream publications on the causes of the global financial crisis, this article sheds light on the individual responsibilities of principals and agents. We will demonstrate that the behavioral assumptions of institutional economics deliver not only an adequate diagnosis for the micro-prudential causes of the global financial crisis, but also arguments for therapy. Before the latter is highlighted in more detail, we briefly describe the basic role of the financial sector as an important economic intermediary in section 2. Section 3 draws an alternative picture of the crisis, namely the abundant liquidity in global financial markets, stressing the role of financial innovations and emerging shadow banking