The Global Financial Crisis

Module 2 The Common Causes of Financial Crises

02 What Causes Financial Crises? Part 1

Why are financial crises so damaging?

01

Financial systems are inherently fragile

02

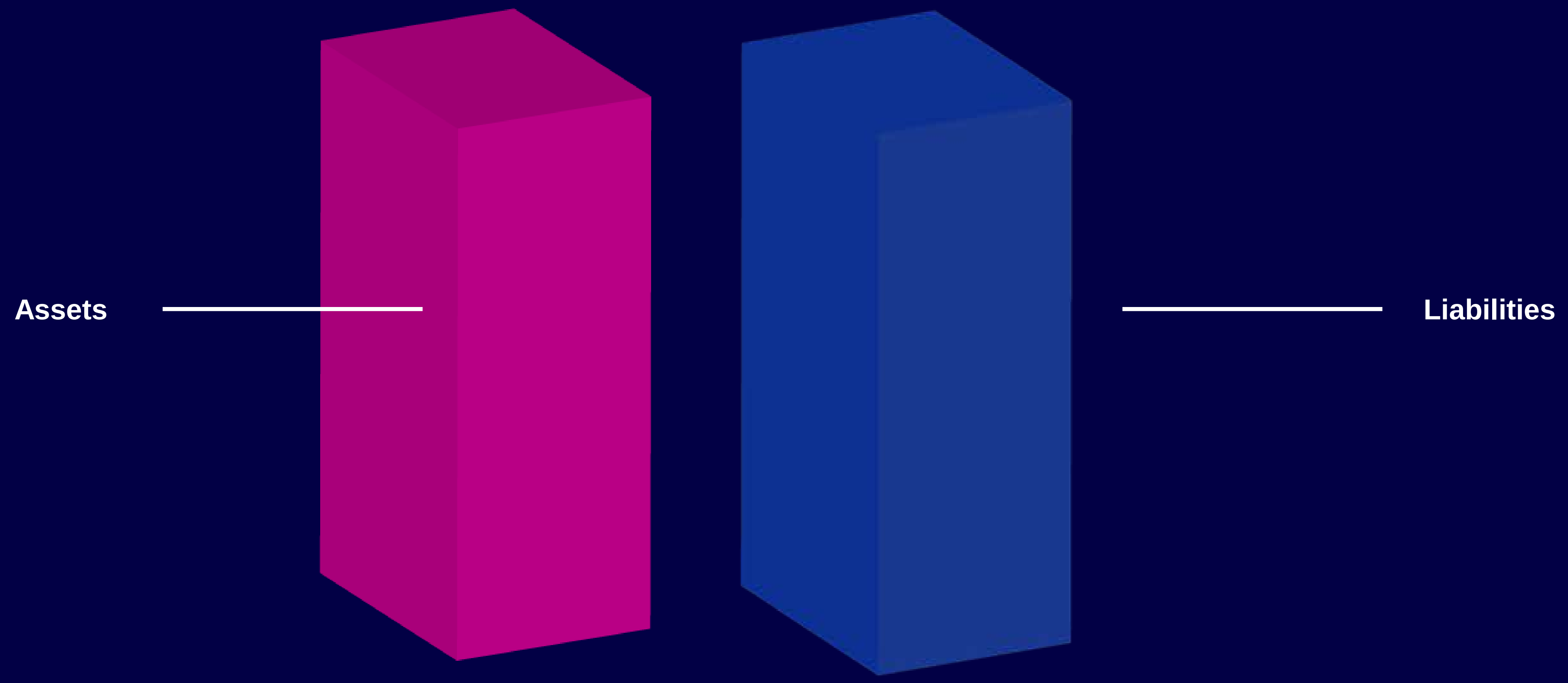
Financial distress can cause severe damage to the real economy

03

Policymakers often mismanage the response

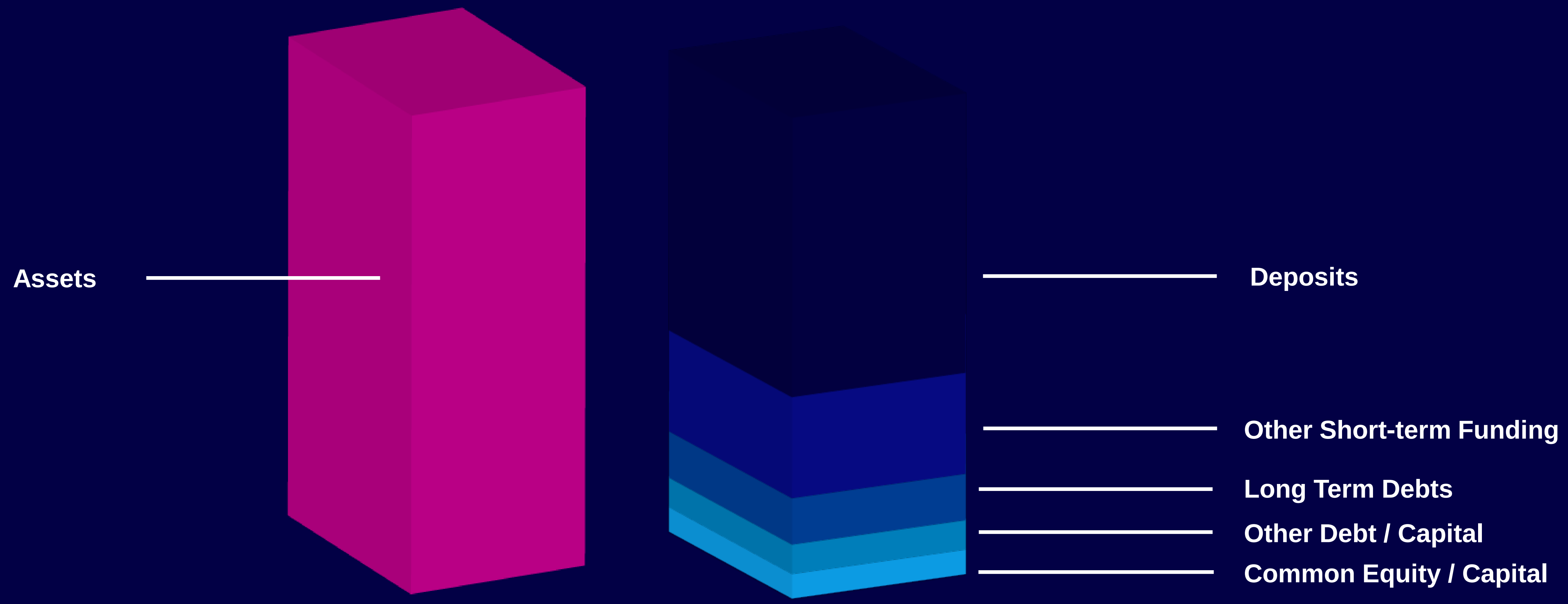
Financial Systems are Fragile

Maturity Transformation and Leverage

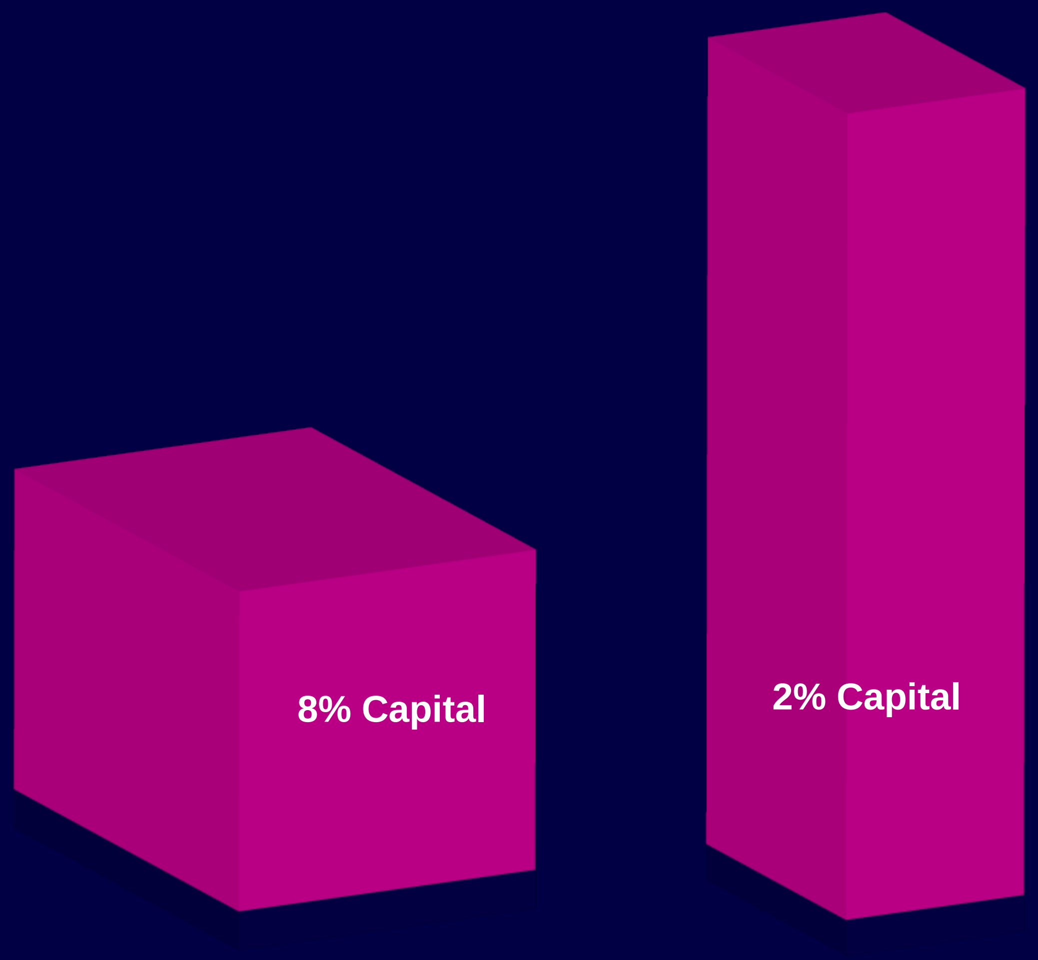


Financial Systems are Fragile

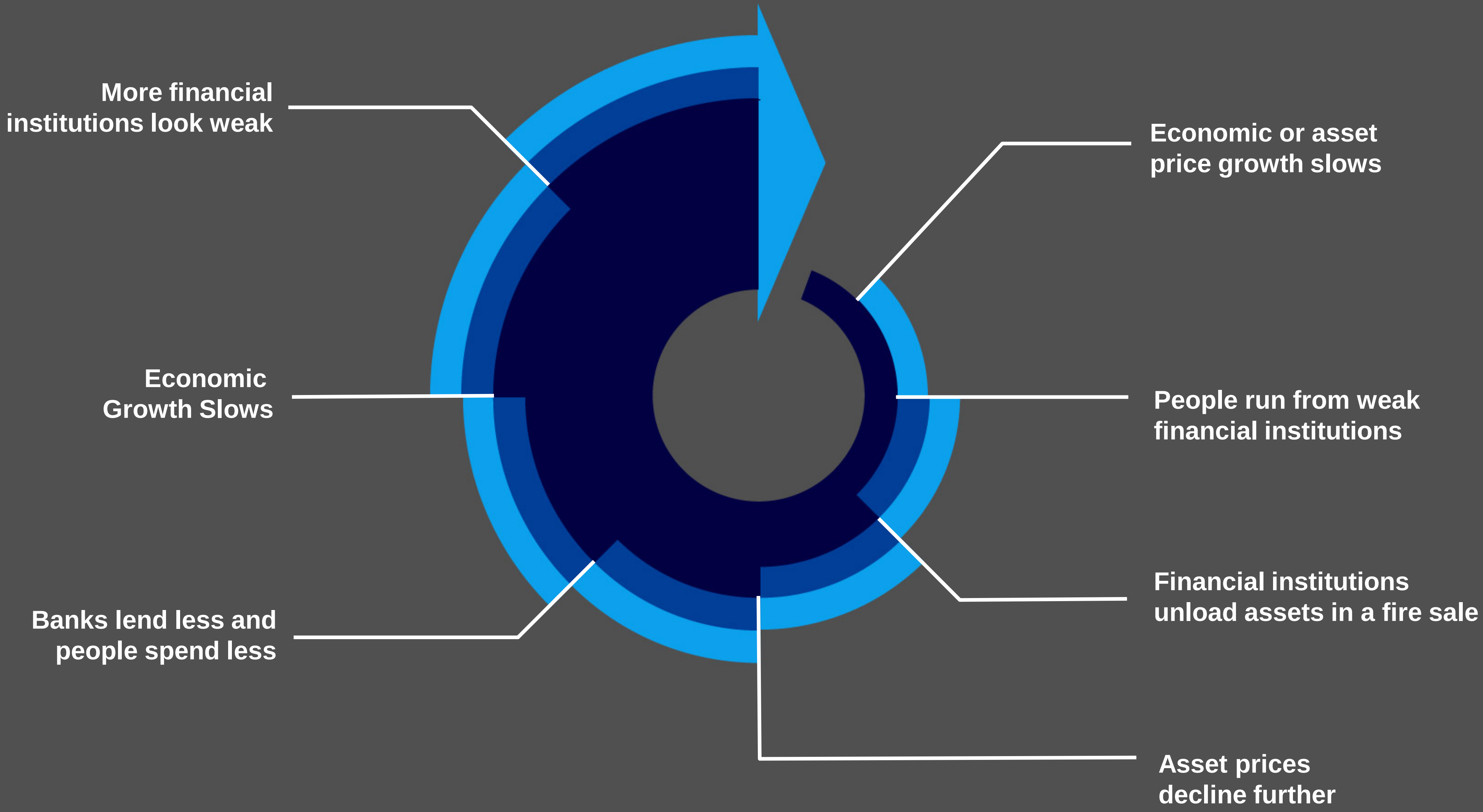
Maturity Transformation and Leverage



Financial Systems are Fragile



Financial Crises Damage the Economy: The Doom Loop



Policymakers Tend to Mismanage the Response to Crisis

Across history, the initial response of policymakers tends to exacerbate the economic damage.

Policy escalates too slowly due to concern about moral hazard, the political risk of bailouts, a mistaken belief that gradual escalation is less risky, or a lack of knowledge about how to break panics and protect the economy.

03 What Causes Financial Crises? Part 2

The Causes of Financial Crises

Monetary Policy and Global Savings Glut

Fraud and Predation

Incentive Problems

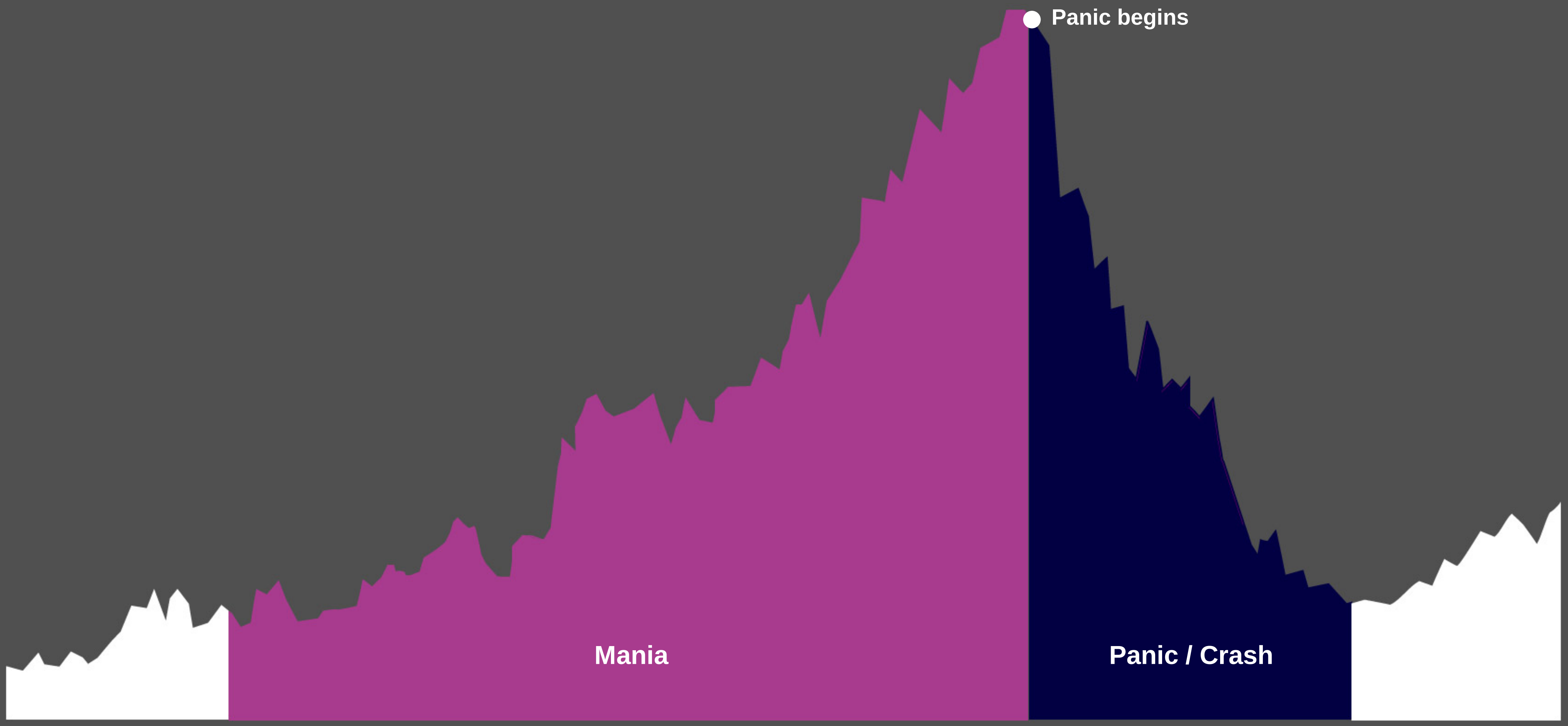
Moral Hazard

Balkanized Regulators and Supervisors

Beliefs

The Anatomy of a Financial Crisis

Kindleberger Chart



Typical Shock vs Systemic Financial Crisis

Elements of Systemic Financial Crisis

Increased debt relative to income

Financed by runnable sources

Risk of contagion and panic

Real economy suffers more due to distress in the financial sector

Monetary policy is less effective due indebtedness and leverage

What matters most for outcomes?

01

Size of the buildup of vulnerabilities

02

Tools and financial capacity ex ante

03

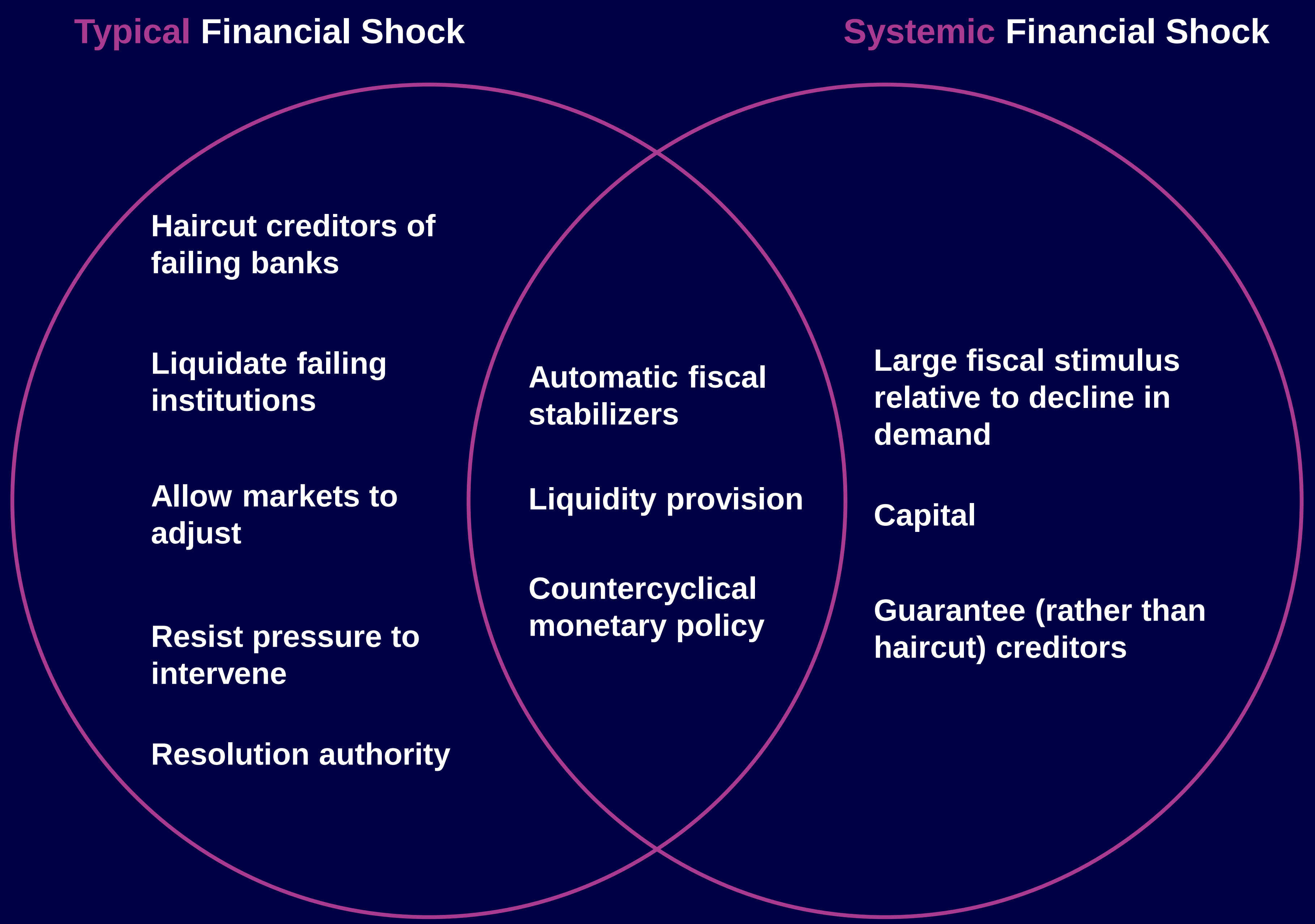
Policymakers’ choices in a crisis

Panics Are Different

The response required to contain a panic and prevent it from escalating into systemic collapse and economic depression is fundamentally different from other financial shocks.

In a panic, contagion risk is acute, even the solvent become illiquid, the entire financial system is vulnerable to collapse, and the fall in asset prices and the contraction in credit threaten much greater overall economic damage.

In this context, policy has to be aggressive in reducing the incentive to run, repairing the lending capacity of the financial system, and offsetting the collapse in private demand.

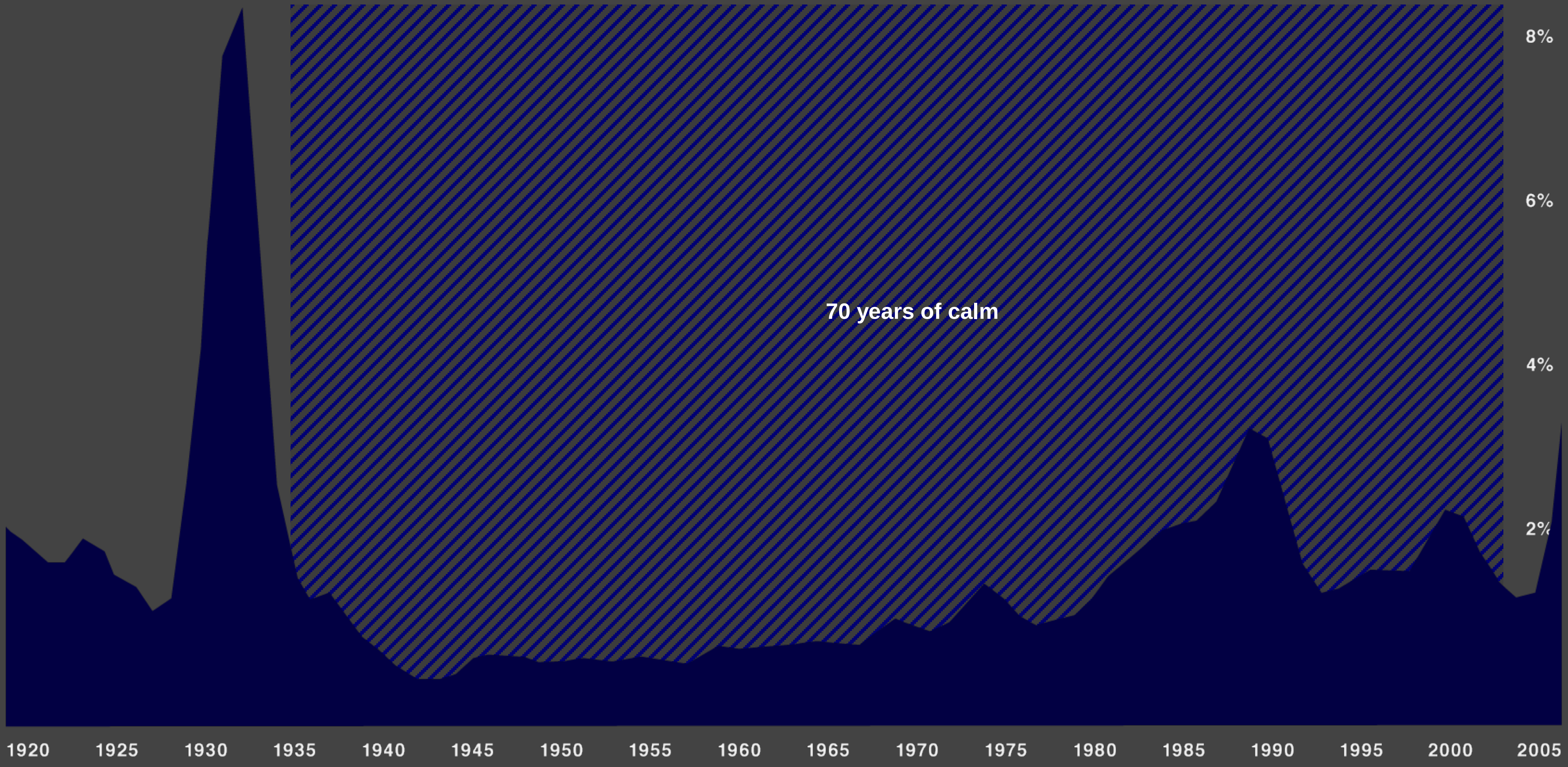

Typical Financial Shock
Systemic Financial Shock
Haircut creditors of failing banks
Liquidate failing institutions
Allow markets to adjust
Resist pressure to intervene
Resolution authority
Automatic fiscal stabilizers
Liquidity provision
Countercyclical monetary policy
Large fiscal stimulus relative to decline in demand
Capital
Guarantee (rather than haircut) creditors

04 Causes of the 2008-2009 Financial Crisis

August 2007 The United States was very vulnerable to a financial crisis.

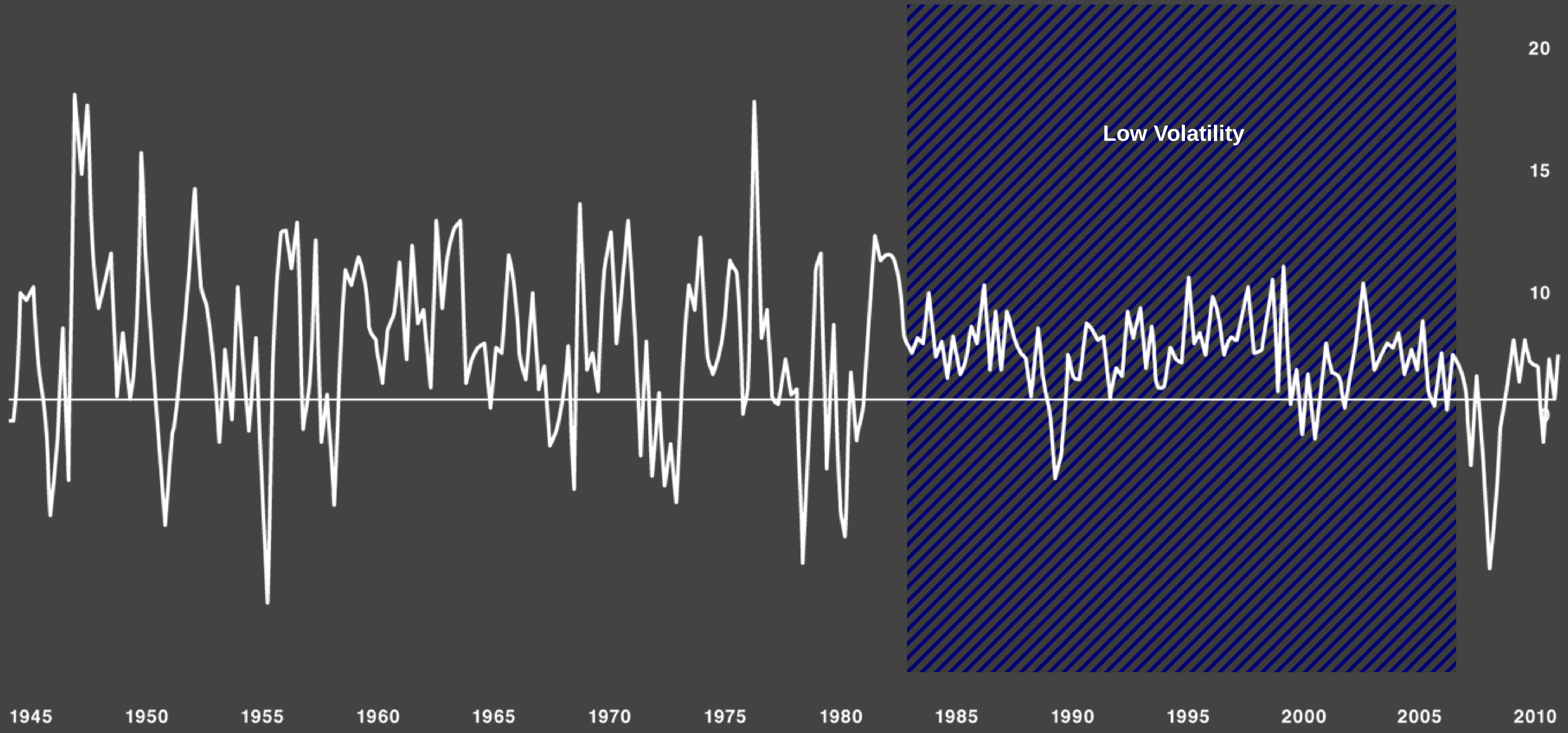
The Quiet Period

Commercial Bank Two-Year Loan Loss Rate



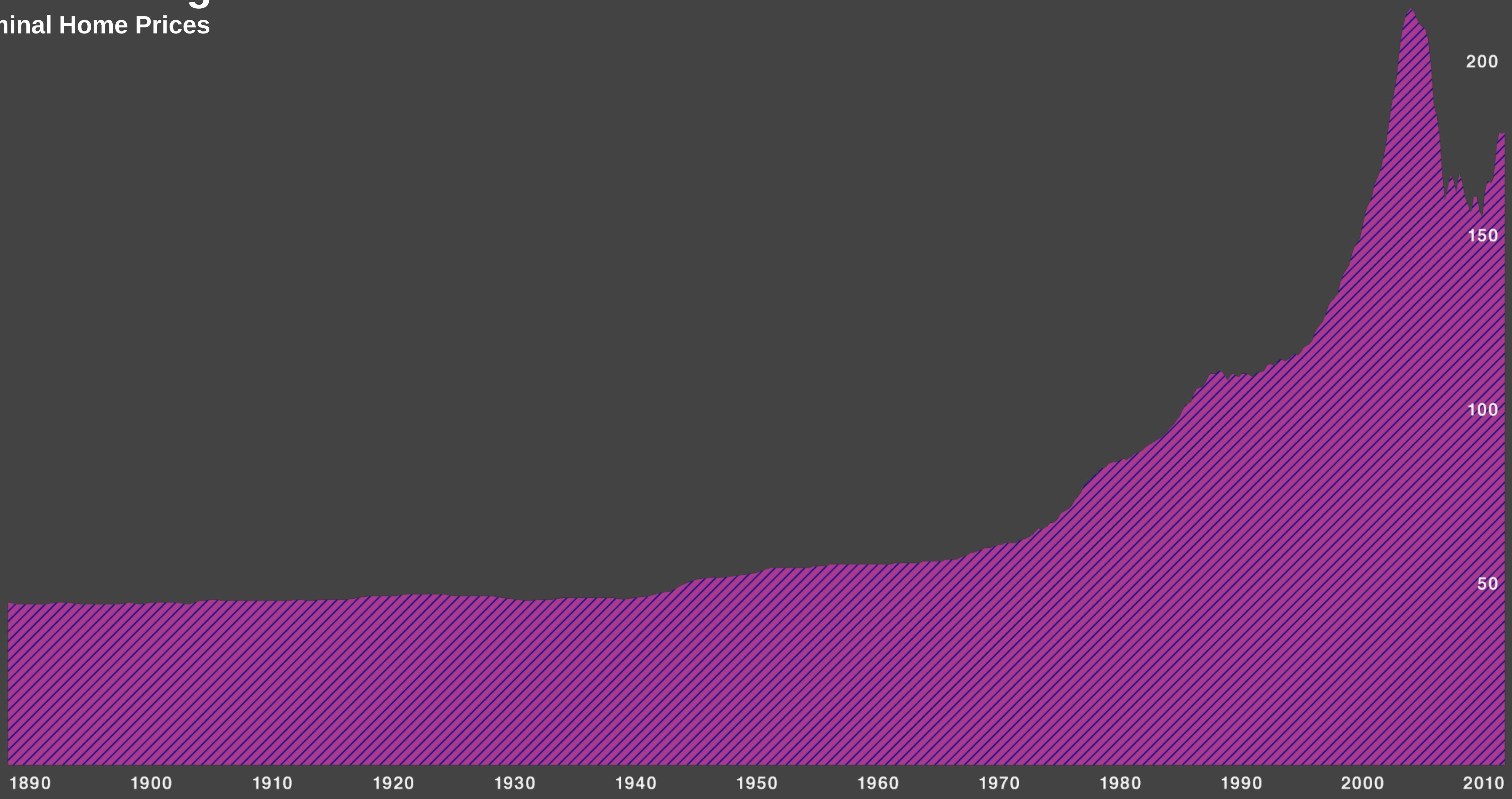
The Great Moderation

Quarterly Real GDP growth



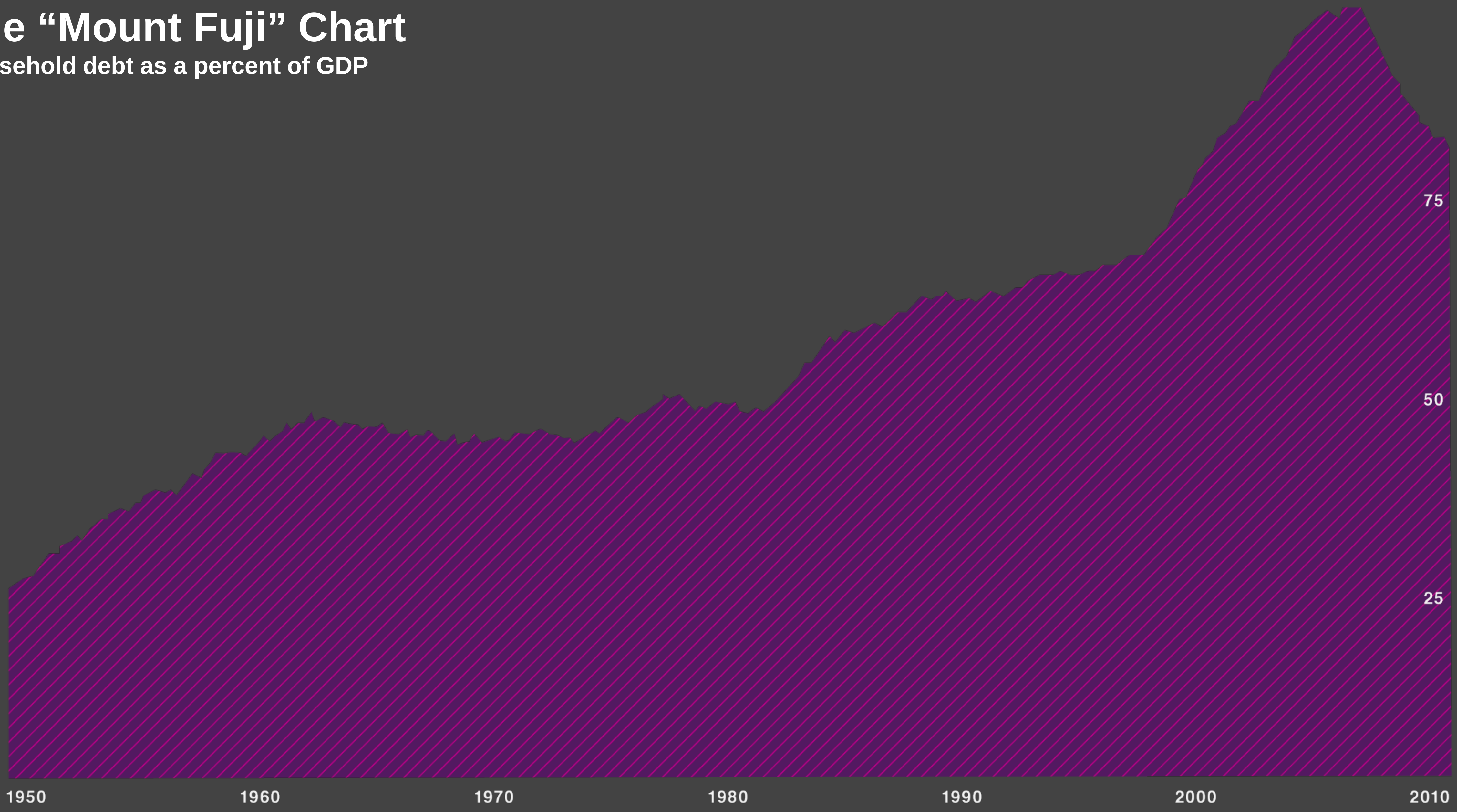
The Housing Boom

Nominal Home Prices



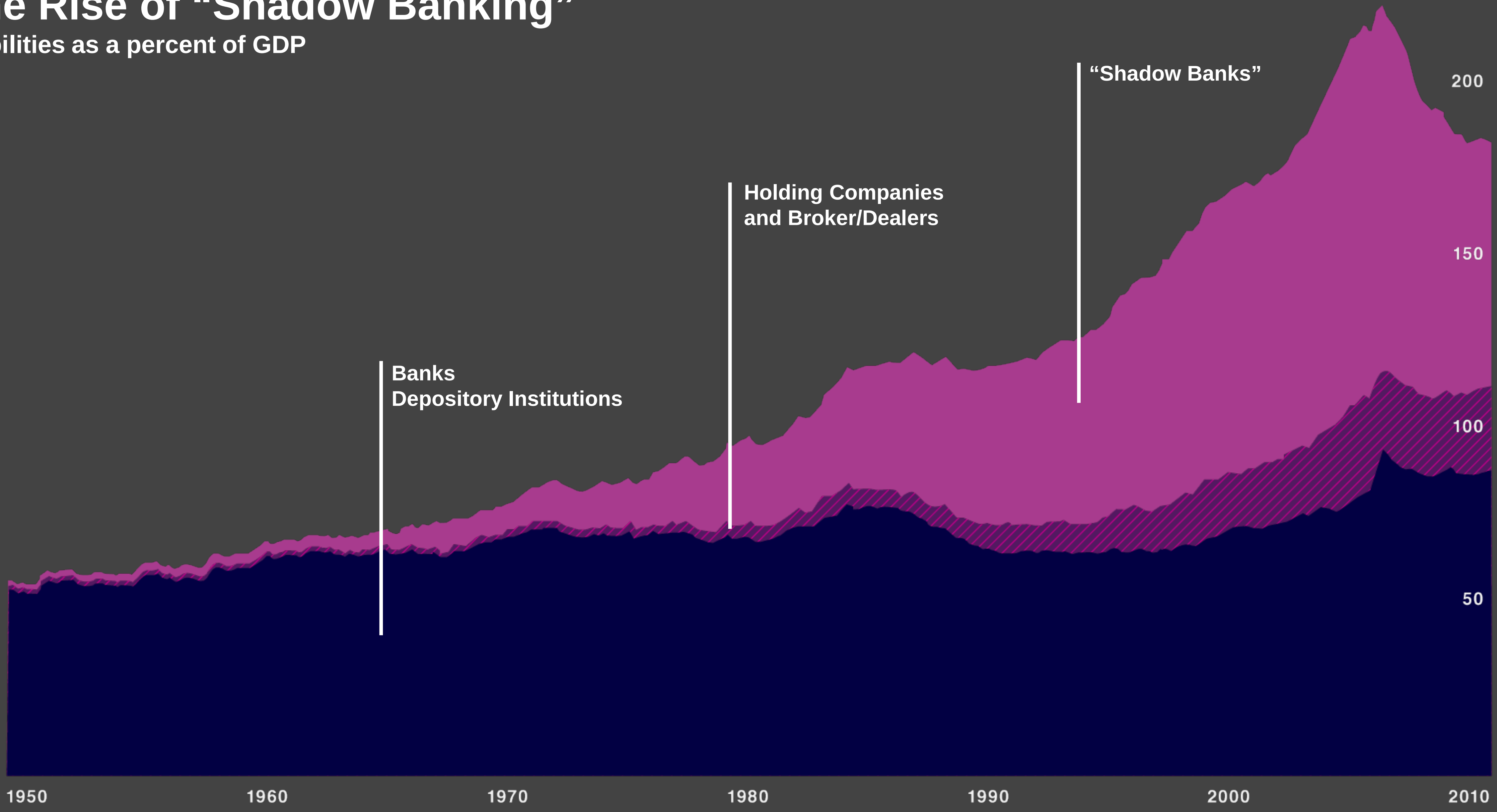
The “Mount Fuji” Chart

Household debt as a percent of GDP



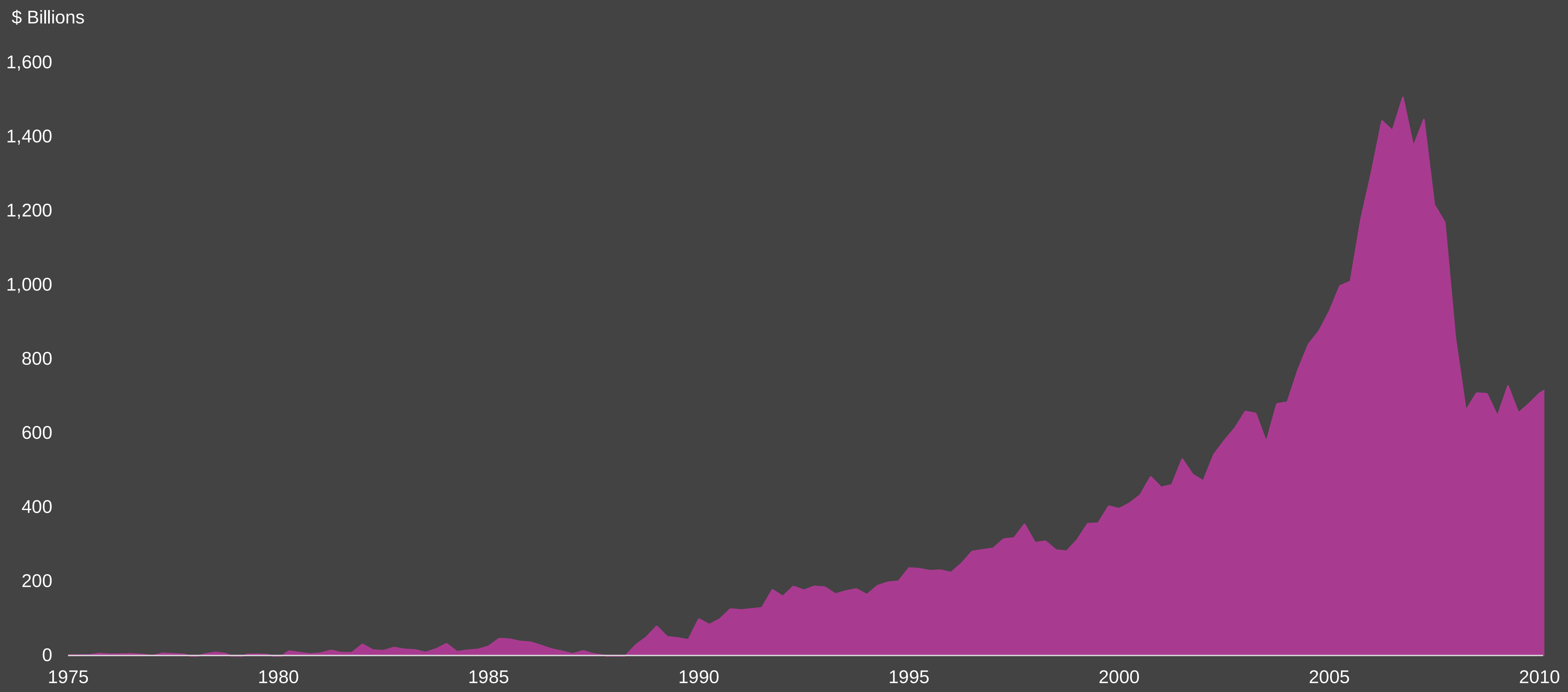
The Rise of “Shadow Banking”

Liabilities as a percent of GDP



Short Term, Deposit-like Liabilities

Net Repo Funding to Broker/Dealers



The United States on the Eve of the Crisis

Belief in more stable future fed a long boom

Increase of debt relative to income

Financed by runnable sources

Creates conditions for panic and collapse

Other Contributing Causes

Monetary Policy and Global Savings Glut

Fraud and Predation

Incentive Problems

Moral Hazard

Balkanized Regulators and Supervisors

05 What Did We Miss and Why Did We Miss It?

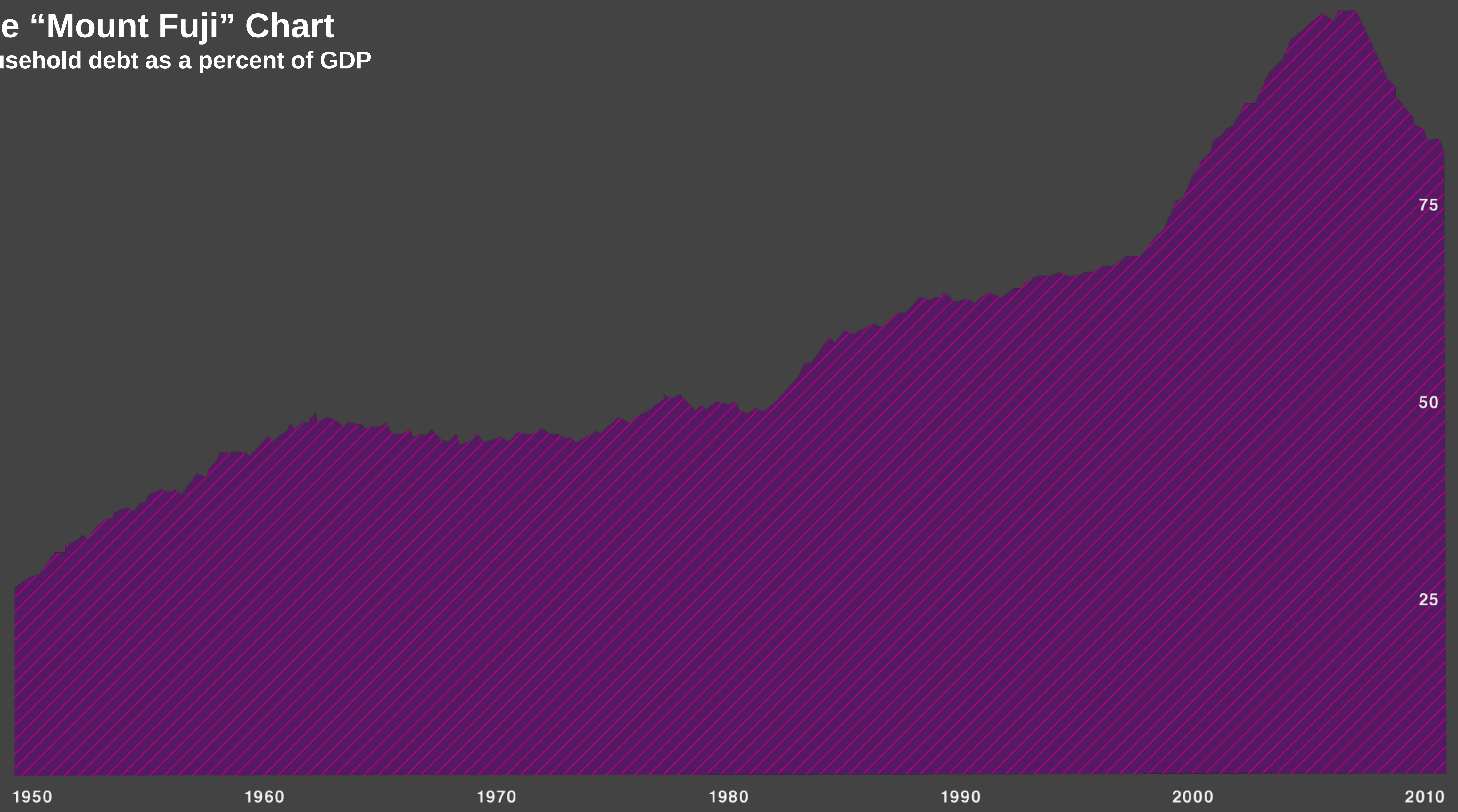
The Challenges of Crisis Prevention

Why did we “allow” the boom to happen?

Why did we allow the financial system to become so vulnerable to panic?

The “Mount Fuji” Chart

Household debt as a percent of GDP



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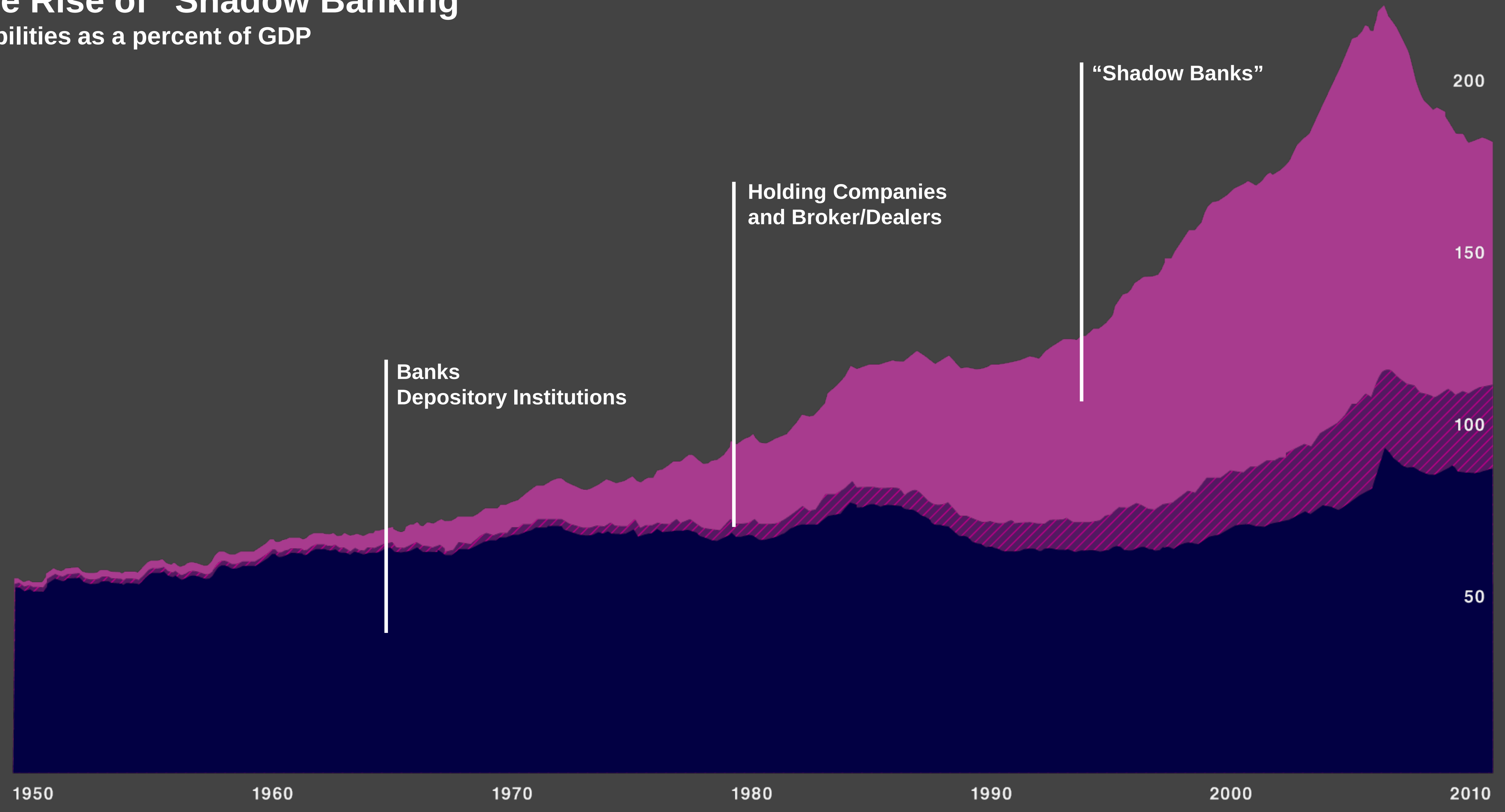


Tools

Before the Crisis
we COULD

Apply capital and liquidity requirements to banks and bank holding companies

Ineffective Tools

Before the Crisis
we COULD NOT

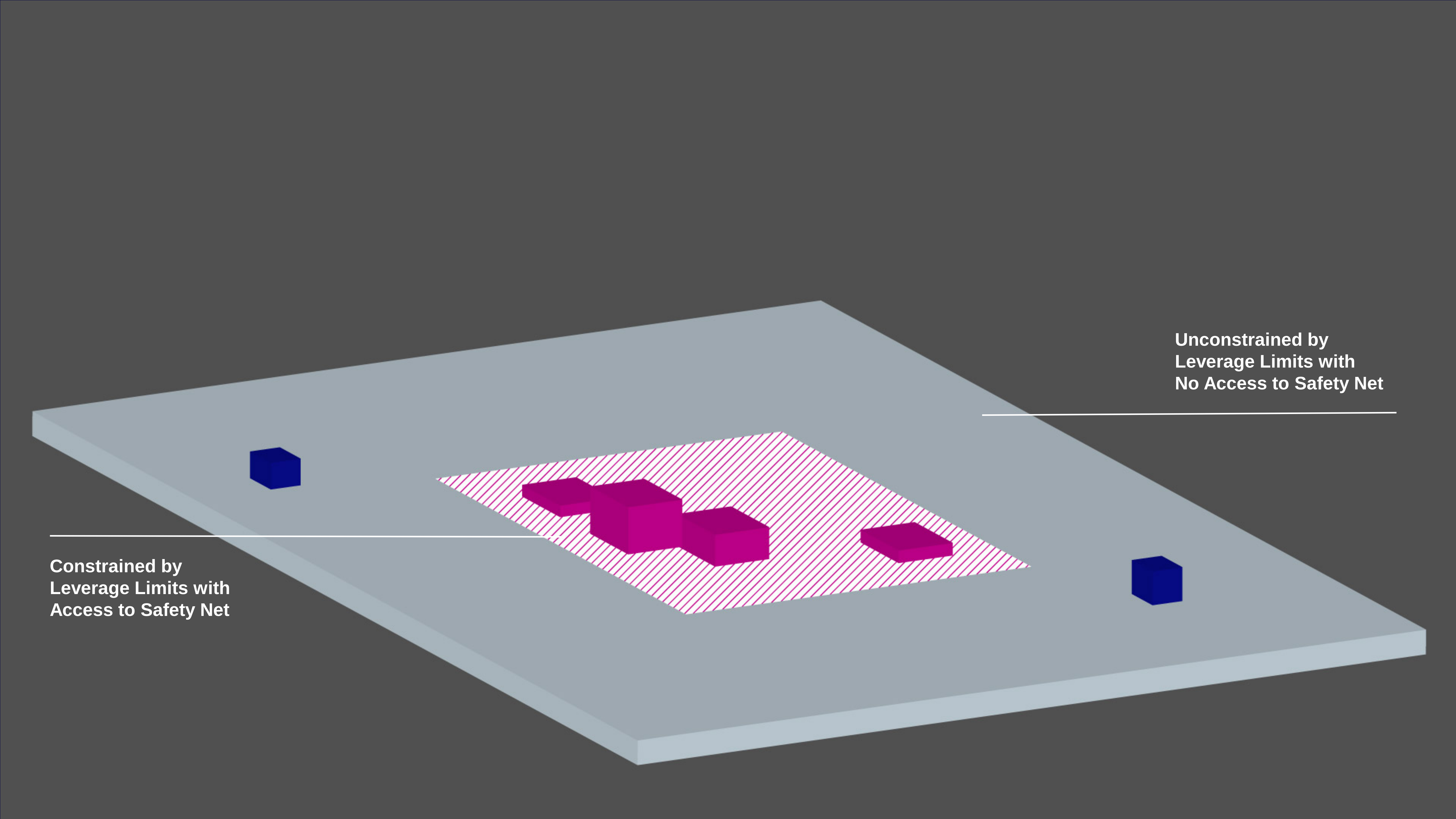
Limit leverage or run risk in the investment banks, government-sponsored enterprises (GSEs), or nonbank financial institutions like AIG or GE capital

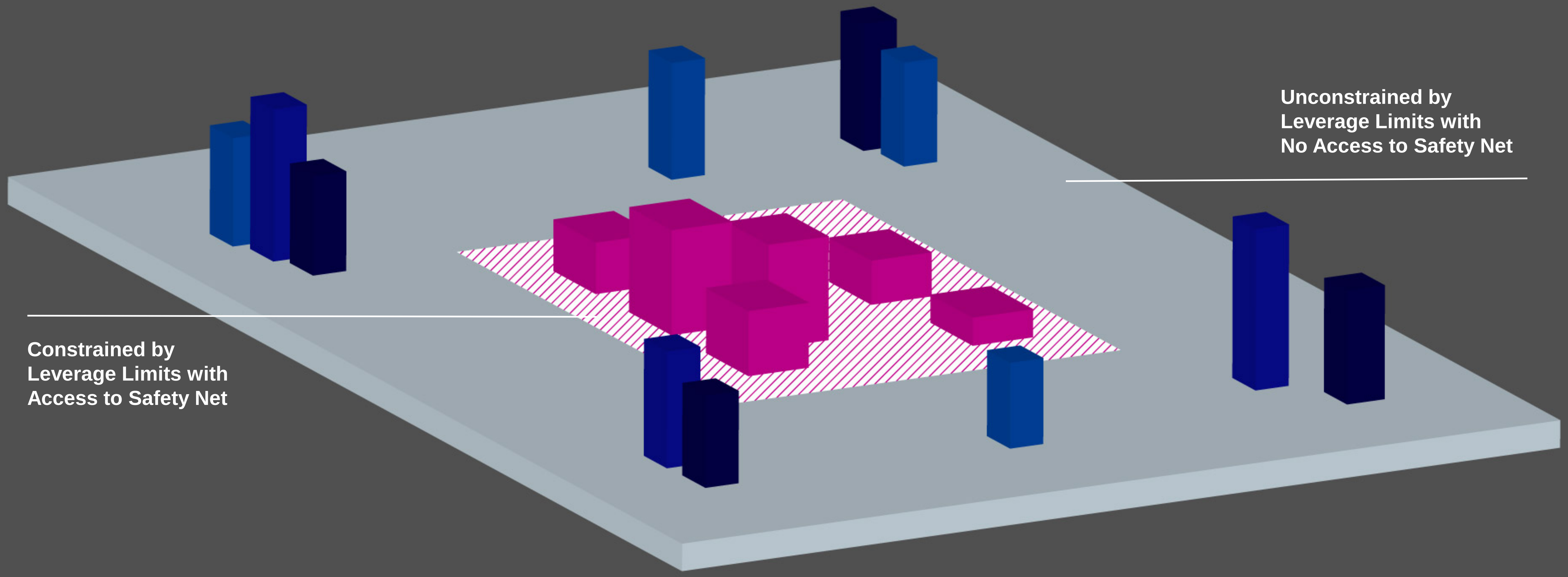
Limit risk in funding or leverage at nonbank subsidiaries of bank holding companies

Adequately constrain the risk in money market funds

Set margin requirements in derivatives

Limit household borrowing relative to home values


Unconstrained by
Leverage Limits with
No Access to Safety Net
Constrained by
Leverage Limits with
Access to Safety Net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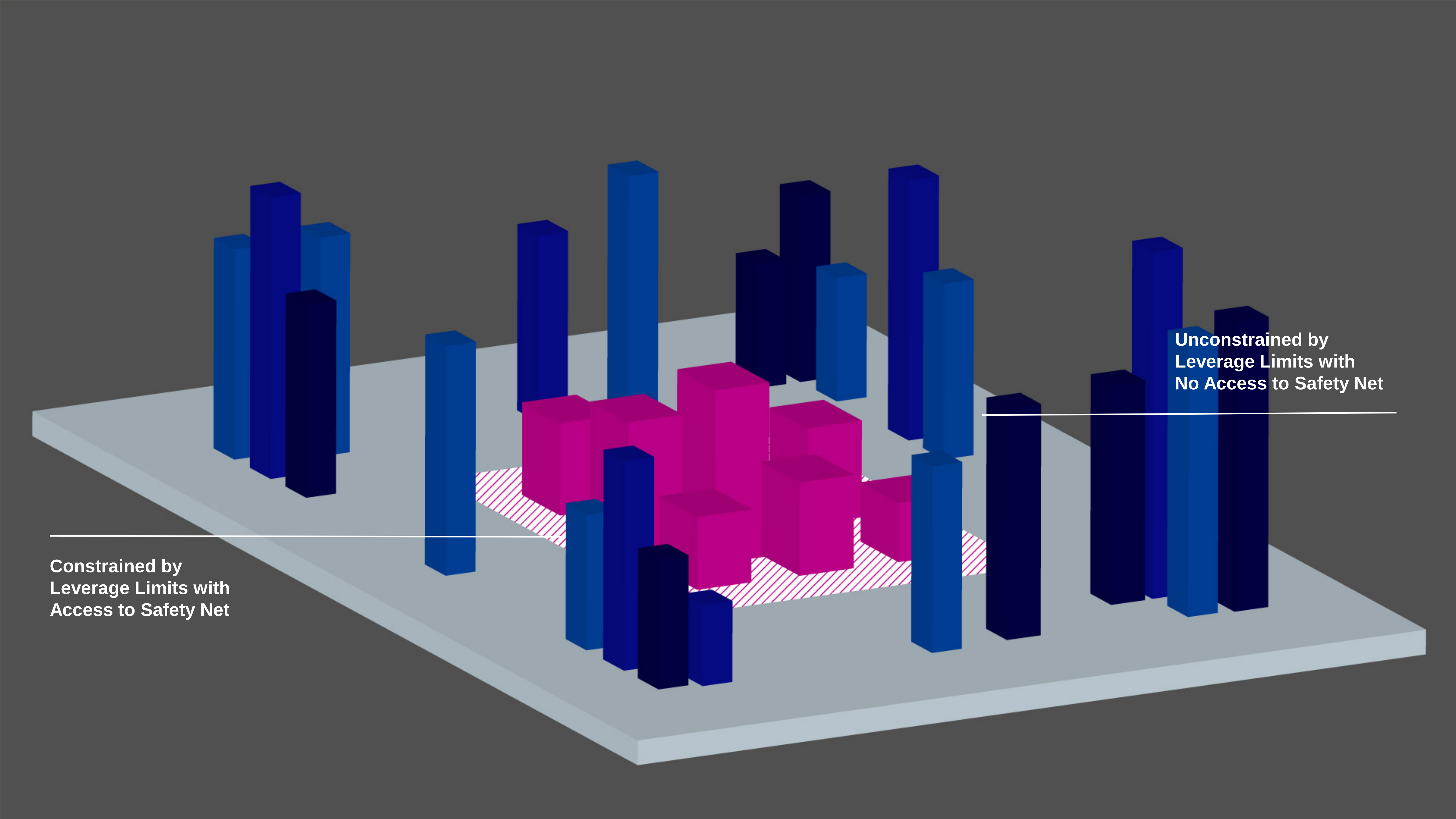
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The Paradox of Prevention

Over time, like water flows around stones in the river, the market will work around the constraints you place on leverage and risk taking.

The tighter those constraints the smaller the portion of the financial system they will end up applying to.

What We Did

Pushed for stronger risk management in banks and investment banks (early stress testing)

Major effort to reduce risk in derivatives

Worked to limit provision of leverage to hedge funds by banks and investment banks

But supervision focused too much on money laundering and other compliance issues, and not enough on systemic risk

What We Did Not Do

Raise capital requirements for banks and bank holding companies

Seek new authority to apply capital requirements to nonbanks

Raise down payment requirements for GSE and FHA guaranteed loans

Limit risk in repo and securities lending

Biggest Miss: A failure of imagination