

The Global Financial Crisis

Module 1 Introduction

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What is a Financial Crisis?

Conceptual Framework

Almost all wealth is embodied in long-lived assets that pay off slowly over time.

Some fraction of that wealth is needed to back short-term safe assets used in transactions (“money”).

Collectively, we cannot all convert our long-term assets to money at the same time.

A “panic” happens when enough people get nervous and try to convert.

A “financial crisis” occurs when a panic (or fear of panic) affects the functioning of the financial system.

Why Study the Global Financial Crisis?

It is an important part of history, by far the most important economic event since the 1930s, and crucial for understanding the world that followed.

It could happen again.

We would like to prevent it from happening again.

If it happens again, we need to be prepared to fight the fire together.

Course Themes

01

Asset Bubbles

02

**New Kinds of
Money**

03

**The Anatomy
of a Modern
Panic**

04

**Fighting the
Panic**

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Course Theme 01: Asset Bubbles

“This time is different ...” (Reinhart and Rogoff, 2008).

Prior to all financial crises, there is a large increase in the price of at least one asset class. When this price later falls, we retroactively label the original increase to be a “bubble”.

In the Global Financial Crisis, the bubble was in housing.

Housing bubbles have been associated with every major financial crisis since WWII.

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Course Theme 02: New Kinds of Money

Through most of the history of civilization, our monetary needs were met primarily by metal-based currencies.

The rise of the modern state has allowed for sovereign-backed “fiat” money.

But ... even stable governments have limits and the demand for money can exceed the supply of metal and sustainable fiat money.

Additional monies are then “manufactured” by the financial system, using private debt backed by collateral.

The history of financial crises is a tour through sad stories of new monies gone bad.

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Course Theme 03: The Anatomy of a Modern Panic

For hundreds of years, panics were easy to spot: depositors would “run” to banks to exchange their banknotes for gold, or to remove their deposits.

The Global Financial Crisis was different, with the panics occurring out of public sight, in the non-bank part of the financial sector. This area of the financial system is often called the “shadow banking” system.

To fully understand the Global Financial Crisis and the efforts required to fight the panic, it is important to understand the mechanics of this modern system.

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Course Theme 04: Fighting the Panic

Going into the Global Financial Crisis, governments all over the world were underprepared, with the available tools built for fighting an old-fashioned bank run, not a modern crisis.

To fight this crisis, these tools – emergency lending, guarantees, capital injections – were extended to creative new uses.

The evidence shows that this panic-fighting was a success, but this success came at the cost of political backlash, in some cases reduced our firefighting capabilities for the next crisis.

Course Organization

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| 02 | The Common Causes of Financial Crises | 09 | Our Responses to the Crisis |
| 03 | Housing and Mortgages | 10 | Responding to Future Crises |
| 04 | Safe Assets and the Global Savings Glut | 11 | Europe in the Global Financial Crisis |
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