A well-functioning financial system solves asymmetric information problem (moral hazard and adverse selection) so that capital is allocated wot its most productive uses.

Financial frictions: which act as a barrier to efficient allocation of capital.

A financial crisis: occurs when information flows in financial markets experience a particularly large disruption, with the result that financial frictions increase sharply, and financial markets stop functioning. The economic activity collapses.

Credit boom and bust : the seeds of a financial crises are often sown when an economy introduces new types of loans or other financial products, known as financial innovation, or when countries liberalization, the elimination of restrictions on financial markets and institutions.

Financial liberalization has a dark side; in the short run, it can prompt financial institution may not have the expertise, or the incentives, to mange boom. Lenders may not have the expertise, or the incentive to manage risk appropriately in these new lines of business.

With less capital, these financial institutions cut back on their lending to borrower-spenders, a process called deleveraging; With less capital, banks and other financial institutions become risker, causing leaner-savers and other potential lenders to these institutions to pull out their funds.

When financial institutions stop collecting information and making loans, financial frictions rise, limiting the financial system’s ability to address the asymmetric information problem of adverse selection and moral hazard.

As loans become scarce, borrower-spenders are no longer able to fund their productive investment opportunities and they decrease their spending, causing economic activity to contract.

Fundamental economic values, their values based on realistic expectations of the asset’s future income stream. The rise of asset prices above their fundamental economic values is an asset-price bubble.

When the bubble bursts and asset prices realign with fundamental economic values, stock and real estate prices tumble, companies see their net worth decline, and the value of collateral these companies can pledge drops.

The asset-price bust also causes a decline in the value of financial institutions’ assets, thereby causing a decline in the institutions’ net worth and hence a deterioration in their balance sheets

With information hard to come be in a period of high uncertainty, financial frictions increase, reducing lending and economic activity.