

Financial Crisis

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Current Event

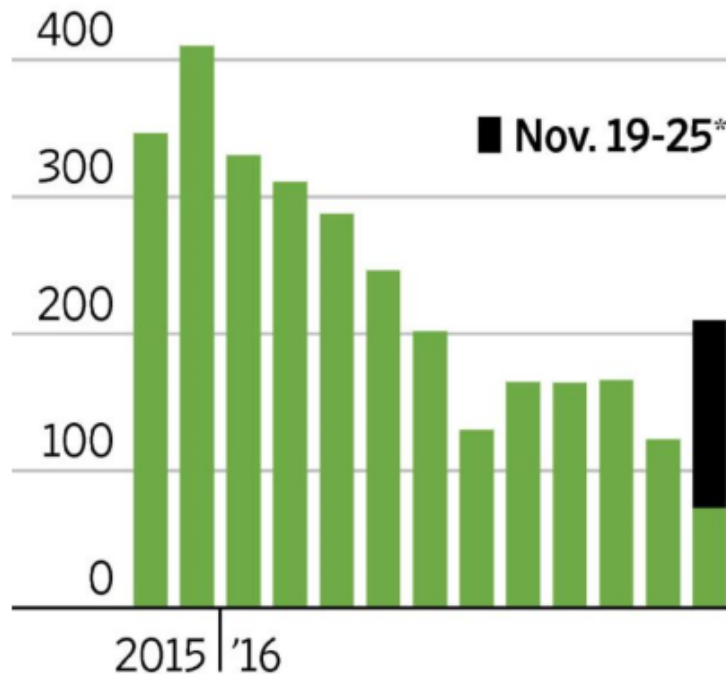
“In the Upside Down World of Zimbabwe, \$100 Trades for \$102,” WSJ, 11-29-16

- Background
 - Hyperinflation => Adopt USD 2009
 - Current political & social unrest, military & police not paid
- Banks
 - Fractional reserve banking: Take deposits, and make loans
 - Bank Run: Cash withdrawals & Cash hoarding to smuggle USD out of country
 - Govt Policy: \$20 limit on daily ATM withdrawal
 - => increases incentive to hoard cash
 - No lender of last resort

Transaction Declined

ATM withdrawals collapsed over the past year as Zimbabwean banks ran out of dollars.

\$500 million



*Spike in withdrawals ahead of introduction of bond notes

Source: Reserve Bank of Zimbabwe

THE WALL STREET JOURNAL.

Current Event

- \$100 bill easy to transport/smuggle out of the country
=>\$102 of small bills exchange for \$100 bill
- Central bank issues new currency (or bond notes)
 - \$10 million in 2016
 - Claimed to be pegged 1:1 to the USD, Credible??
 - If new currency becomes official => Capital flight
 - NCO => S of ZBN => e

Outline: Unit VI, Section MI 1

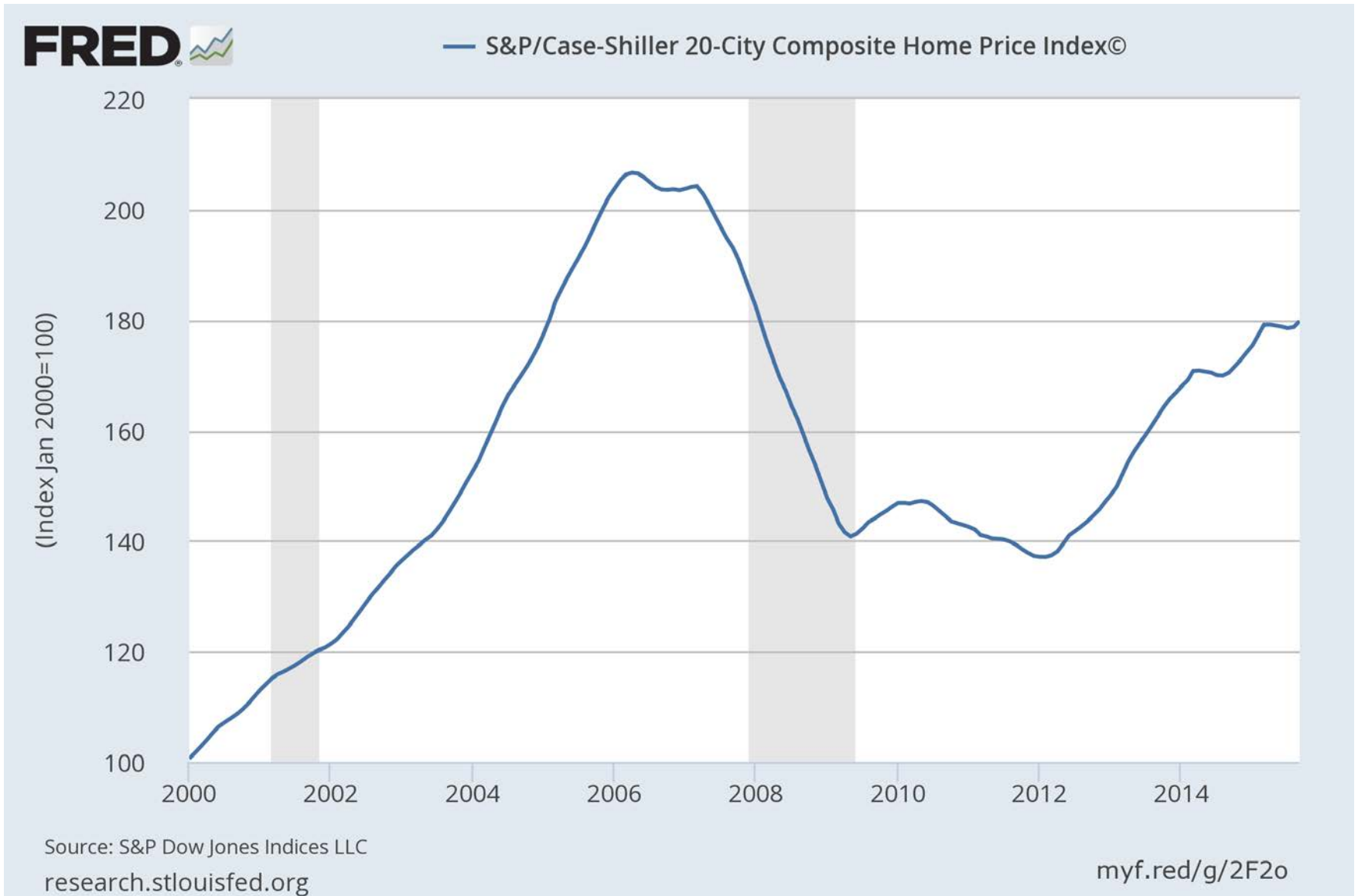
- I. Housing Bubble
- II. Financial Intermediation

I. Housing Bubble

- 2000-2007: Housing prices begin rapid increase
- Most basic explanation => Demand for Housing increases
- Many new people entered housing market:
 - Subprime mortgage borrowers
 - Other residential investors
 - First time home buyers
 - Purely speculative homebuyers
 - Foreign investors (securitization)

⇒ Feeds the froth in the housing bubble

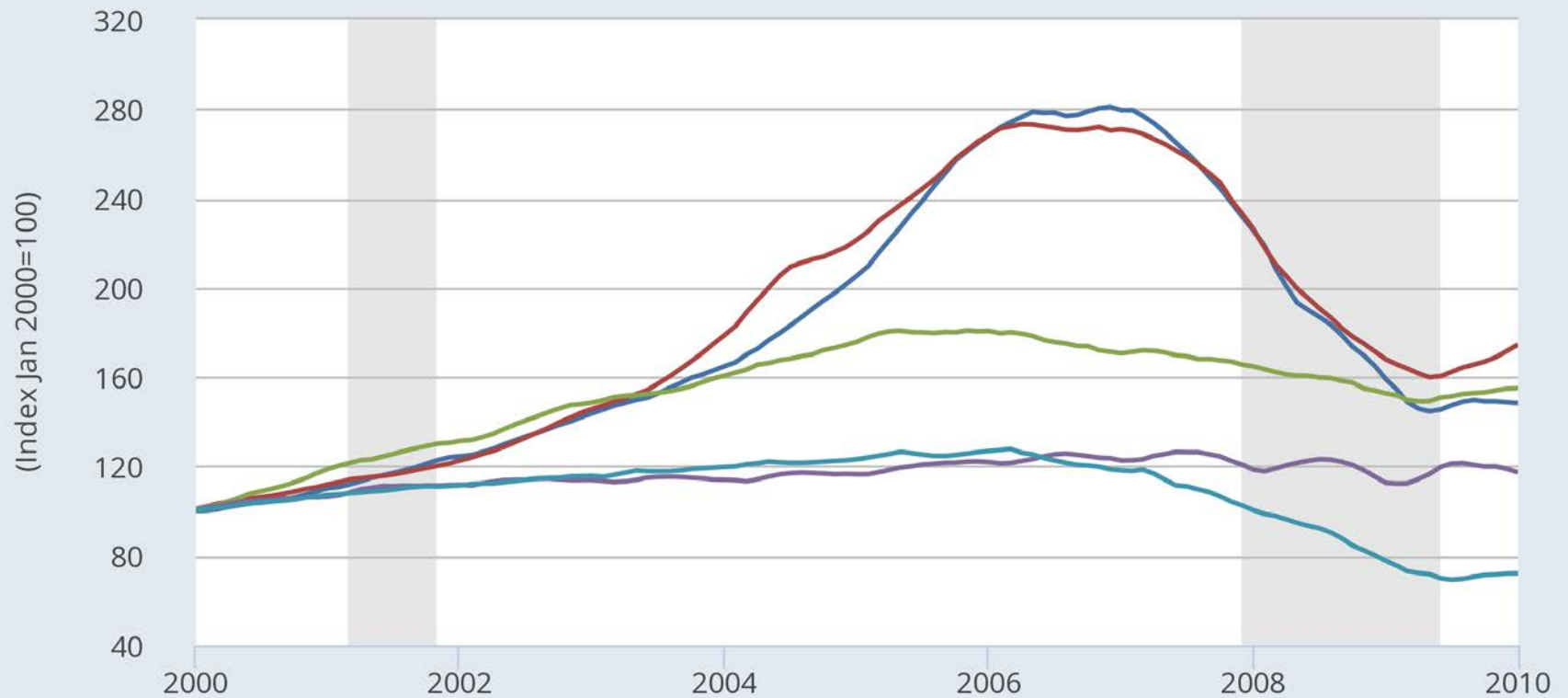
Evolution of House Prices



Heterogeneity Across Cities



- S&P/Case-Shiller FL-Miami Home Price Index©
- S&P/Case-Shiller CA-Los Angeles Home Price Index©
- S&P/Case-Shiller MA-Boston Home Price Index©
- S&P/Case-Shiller TX-Dallas Home Price Index©
- S&P/Case-Shiller MI-Detroit Home Price Index©



Subprime Borrowing/Originations

- Characteristics of subprime borrowers
 - Low income, low job security, low assets
- Subprime borrowing increases
 - Lending standards decrease
 - The American dream
 - Build your net worth as housing prices increase
 - “Throwing away rent money”

The Subprime/Housing Bubble

Year	Total Mortgage Originations (Billions)	Subprime Originations (billions)	Subprime Share in Total Originations (% of dollar value)
2001	\$2,215	\$190	8.6%
2002	\$2,885	\$231	8.0%
2003	\$3,945	\$335	8.5%
2004	\$2,920	\$540	18.5%
2005	\$3,120	\$625	20.0%
2006	\$2,980	\$600	20.1%

Housing Bubble & Banks

Financial Intermediation

- Lending standards decreased
- Mortgage lenders, banks, paid a fee for each new mortgage
- Incentives??
- [Banks allowed to leverage more]

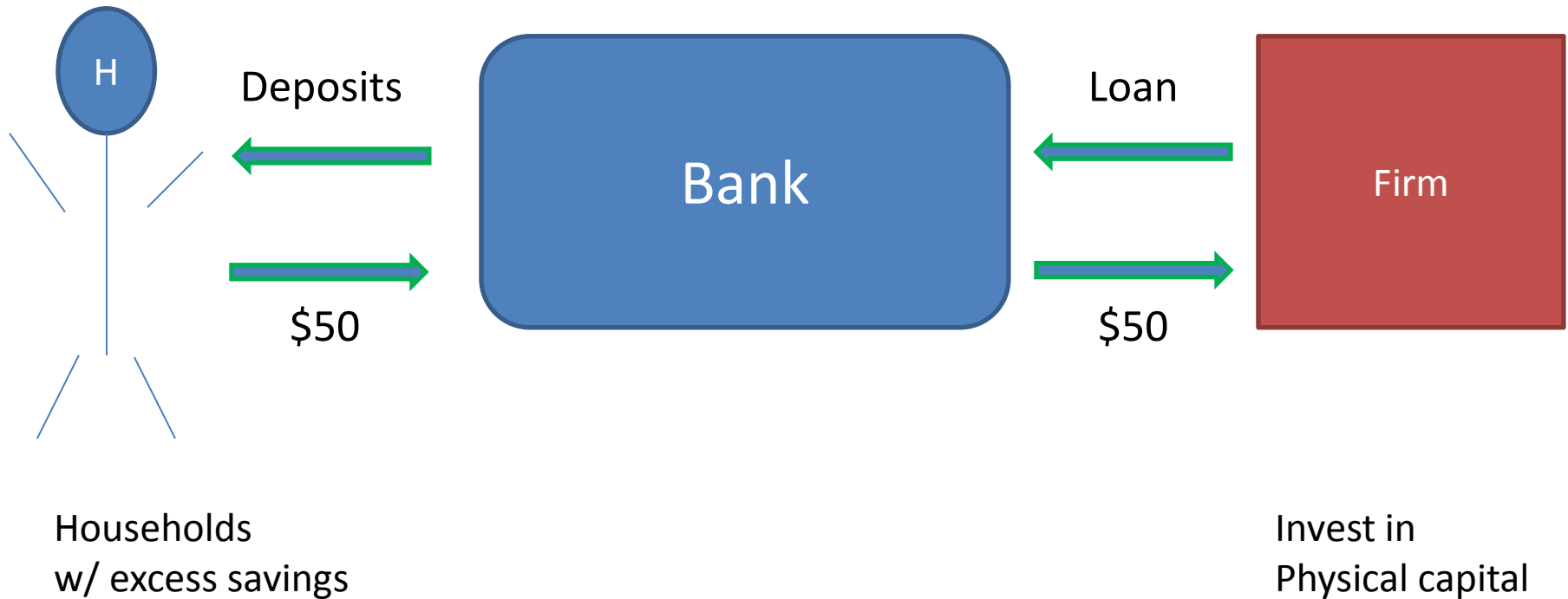
Other Explanations

- Global savings glut
 - BRIC's rapid rise => Excess supply of savings =>
 - From US perspective: NCO shifts in => $r \downarrow$ => $I \uparrow$
- Low interest rates after dot.com bust
 - Alan Greenspan lowers interest rates in 2000
 - Could US monetary policy potentially fuel next bubble?
- [Credit Rating Agencies]
 - [incorrectly rates many subprime MBS as AAA]

II. Financial Intermediation

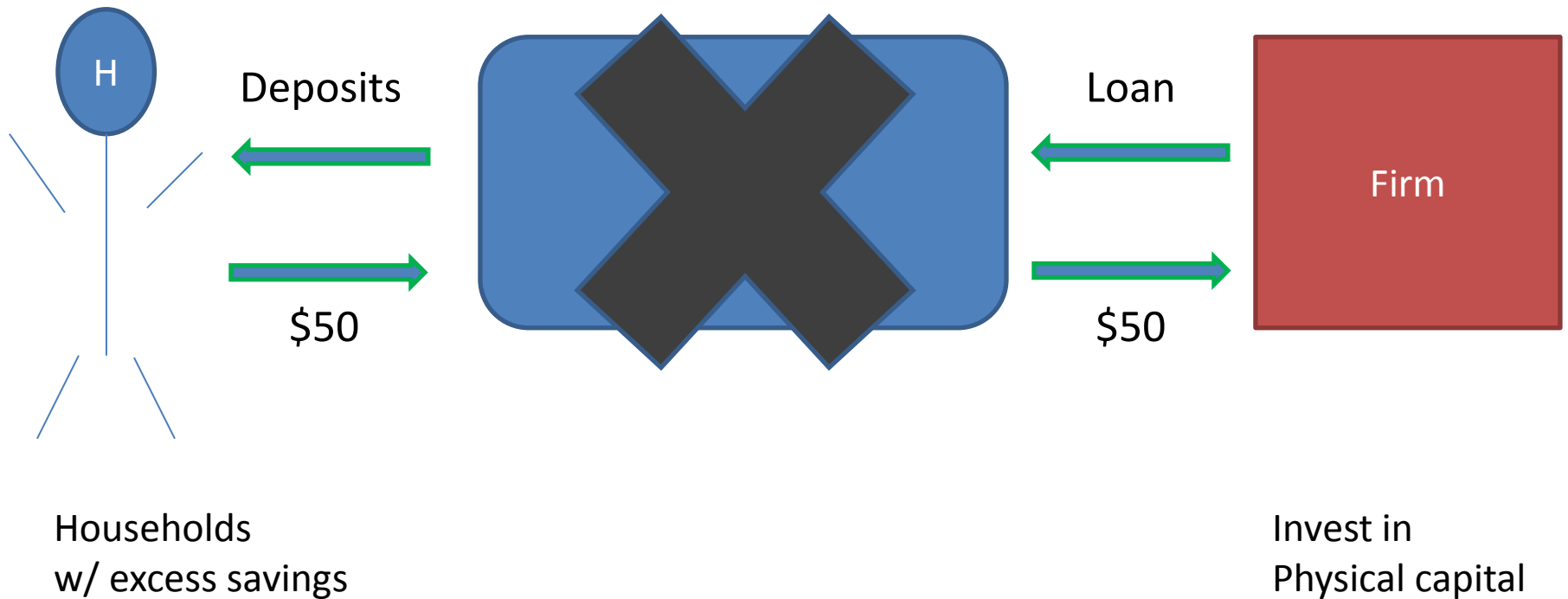
Banks

Bank is a Financial Intermediary



Banks

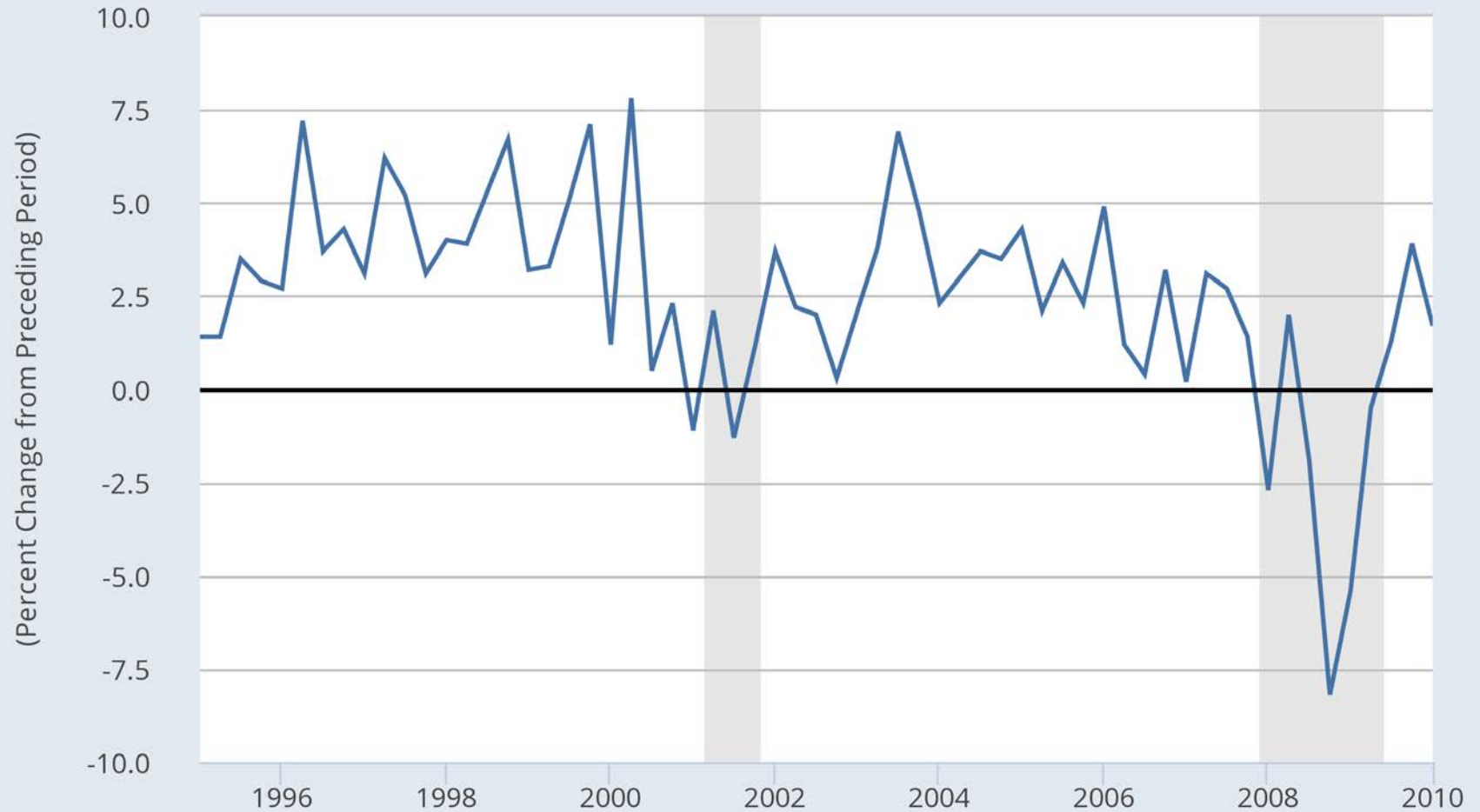
Financial intermediation breaks down



Comparing the Financial Crisis and Dot.com Bubble

FRED 

— Real Gross Domestic Product

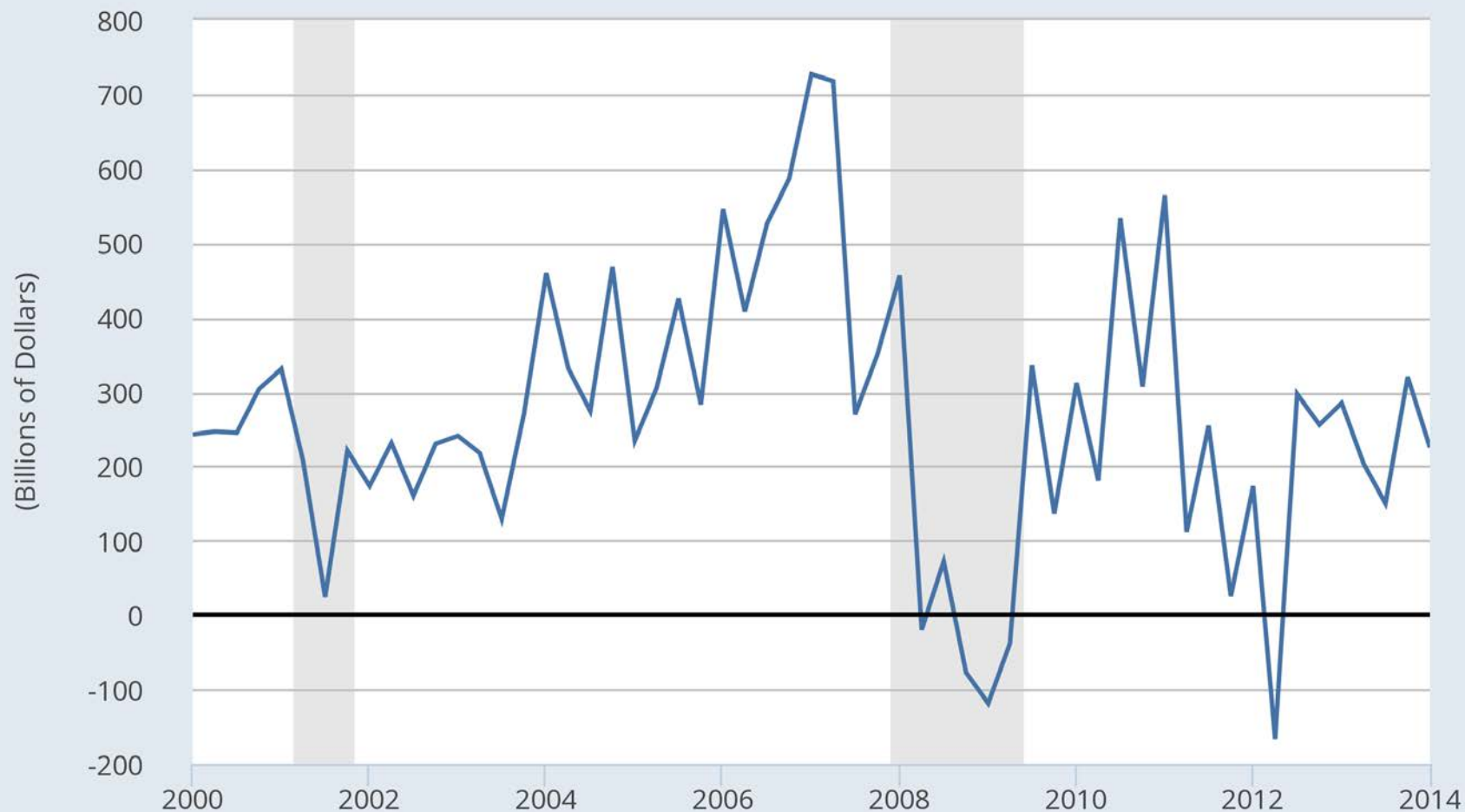


Source: US. Bureau of Economic Analysis
research.stlouisfed.org

myf.red/g/2FrX

Financial markets

- Financial Crisis
 - Households: $C \downarrow$
 - Firms: $I \downarrow$
- Financial capital flows from US perspective:
 $NCO \uparrow$



The Paradox of Financial Crises

“Bailing out banks are deeply unpopular. It is like aiding the arsonist.”

- Financial panic, left unchecked
⇒ Possible Great Depression again
- Too Big to Fail
 - Domino effect: Bank 1 collapses => Bank 2 collapses
=>
- Moral hazard
 - Risk-taking banks are bailed out by taxpayer \$\$
=> Increased risk-taking by banks in the future

[Dodd-Frank Bill]

- [Mitigate future risks through new regulation]
 - Federal Stability Oversight Council
 - Fed as super regulator
 - Stress tests
 - Living wills
 - Higher capital cushions
 - ...