Lecture 17: The Global Financial Crisis

ECON435: Financial Markets and the Macroeconomy

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Capital Inflows to the US

- Export-oriented growth (China, Vietnam, …)
- Precautionary savings (East Asia, oil exporters, …)
- → Large capital inflows to the US in late 1990s
- → Internet bubble & bust
- → Aggressive interest rate cuts by Fed, but the corporate sector was still hurting
- → Consumers took advantage of low rates

Deregulation

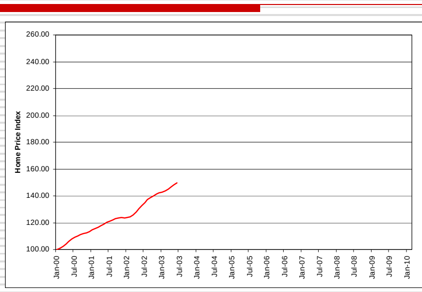
- After the fall of communism, capitalism was triumphant
- → belief that the market was infallible

- Zealous deregulation
- → prepared ground for securitization, credit default swaps etc.

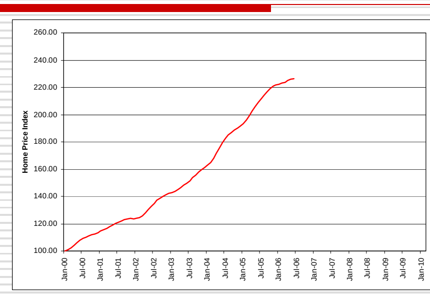
Financial "Innovation"

- "squeezing the most AAA from a pool of underlying assets"
- wrong models – attempt to diversify systematic risk
- agency problems between
  - home owners
  - mortgage brokers
  - banks
  - investment banks
  - investors

Case-Shiller Home Price Index



Case-Shiller Home Price Index



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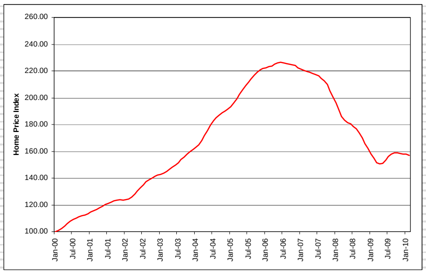

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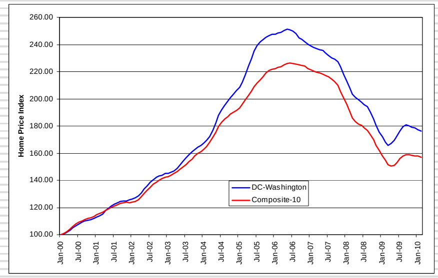


The Party Ends Mid-2006

- End of the pyramid scheme: no more borrowers that can buy at ever rising prices
- Subprime borrowers start defaulting
- Home prices start declining
- Banks start losing money

Risk-Taking in the Financial Sector

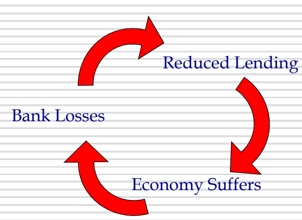
- Financial sector held large amounts of risk:
  - Managerial incentives for risk-taking and herding
  - Traders had incentive to take hidden "tail" risks
  - Financing by short-term debt

→ Major crash almost inevitable

The Financial Meltdown

- When companies lose money: they shrink their business
- normally: this works: Chrysler, GM, …
- in the financial sector:
  - shrinking affects the rest of the economy
  - causes negative feedback loops

Feedback Loops in Financial Sector



Policy Debate: Financial Regulation

Important elements:

- Resolution authority: wind up failed firms
- Require more capital buffers in the system
- Derivatives reform: clearinghouses etc.

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European Debt Crisis

- Peripheral European countries (Greece, Ireland, Portugal, Spain, …) joined the Euro area in 1999/2000
- interest rates fell overnight from to German levels
- countries took on large debts (in Greece, government debt; in the rest private debts)
- large debt-financed boom
- followed by an even larger bust

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European Debt Crisis

Policy Options:

- obtain large bailouts
- default
- leave the Euro area

Risk of contagion…

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Hot Money to Emerging Markets

In recent years, emerging economies were the main growth engine of the world economy

- → Investors have piled money into them, leading to rising exchange rates and (unsustainable) credit booms
- → Risk of new bubbles, e.g. in Brazil, China,…
- → "Currency wars:" countries attempt to fight the destabilizing capital inflows

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