The Global Financial Crisis

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What caused the crisis?

- The conventional wisdom is that the basic causes of the crisis was bad incentives in
  - the origination of mortgages
  - the securitization of them
  - the provision of ratings for securitizations
  - risk management systems

But it seems much more is going on…

- The large global impact of the crisis suggests that the problems with subprime mortgages was a symptom rather than the cause

- The main problem is that there was a bubble, first in stock prices and then in property prices, and we are now suffering the fallout from the collapse of that

What caused the bubble?

- The monetary policies of central banks particularly the US Federal Reserve were too loose – they focused too much on consumer price inflation and ignored asset price inflation

- Global imbalances – the Asian crisis of 1997 and the policies of the IMF led to a desire among Asian governments to save funds

Why are things so bad?

- People made decisions based on the wrong asset prices for more than a decade

- In particular, people in the US lowered their saving and increased their borrowing in the belief that asset prices would continue to rise

- Now that the bubble has burst it is very unclear what the correct prices of stocks, property and commodities will be going forward and how much they should save

Price volatility is extremely high

- Stock prices around the world have been exceptionally volatile
- A few months ago the prices of commodities such as oil were at all time highs, now they are much lower
- Exchange rates have been very variable
- Where will prices be next month let alone next year?

Price uncertainty is chilling the global economy

- Individuals do not know their wealth – how much should they be saving now the asset price bubble has burst?

- Firms do not know how much to produce or what investments to make

- These problems are considerably exacerbated by the financial crisis and the feedback effects it is having

The financial crisis

- The collapse in property prices in the US has led to enormous disruption in the global financial system
- The first problem was with subprime mortgages
- Now the problem has become a general problem of credit risk because of the uncertainty about long term prospects

- There has been a flight to quality with government securities particularly in the US, Japan and Germany being regarded as the safest ones

- The crisis in the financial system has created large feedback effects into the real economy

- Economic activity is slowing down everywhere in the world

To summarize:

- The first aspect of the problem is the development and subsequent bursting of the stock and property bubble and the need for people to revise their saving decisions

- The second aspect is that this problem is considerably exacerbated by the poor functioning of the financial system in the crisis

Why has the financial system performed so poorly?

- Why didn’t regulation help?

- Banking regulation is different from other kinds of regulation in that there is no wide agreement on the market failures it is designed to correct

- It is backward looking in the sense that it was put in place to prevent the recurrence of past types of crises

Standard rationale (cont.)

- But what are the benefits and costs of regulation?
- What exactly are the market failures?
- The Basel agreements illustrate the lack of a widely agreed theoretical framework

The market failures

The most important are:

1. Inefficient liquidity provision

2. Mispricing due to limits to arbitrage

3. Contagion

Going forward

- Central banks and governments need to be much more focused on preventing bubbles and global imbalances than in the past – this is the real cause of the crisis

- Banking regulation needs to focus on correcting market failures rather than being imposed ad hoc as has been done historically

What’s going to happen next?

- What precedents provide the best guide?

- The US has not had situations like this on a nationwide basis since the Great Depression but in other parts of the world there have been many financial crises

- What is the most similar?

Japan in the 1990's

- In the 1980's the Japanese economy boomed
- There were huge increases in stock prices and particularly property prices
- Was it a bubble?

The Japanese Bubble

- The Nikkei index was around 10,000 in the mid-1980’s and peaked at just under 40,000 at the end of 1989
- In recent weeks almost 20 years later it has been trading around 7,000-8,000
- What about property prices?

The Lost Decade in Japan

- Property prices peaked in 1991 and then fell continuously for about 15 years ending up around 70-75% from their peak value

- This caused huge problems in the banking system that spilled over into the real economy

- Growth fell from being among the highest in the world to the lowest

Will it be as bad in the US?

- Many argue the bubble in stocks and property was smaller in the US
- Stock prices corrected in 2001 (but maybe there is more to come?)
- The deviation from the long term growth trend in property prices in the US was about 25%
- They have fallen about 25% so far suggesting they are not far off the long term trend

Except…

- Japan had a very different kind of economy in terms of the way that firms and banks reacted to the downturn

- In particular firms, place great weight on the interests of employees and other stakeholders and not much weight on shareholders

Firm priorities

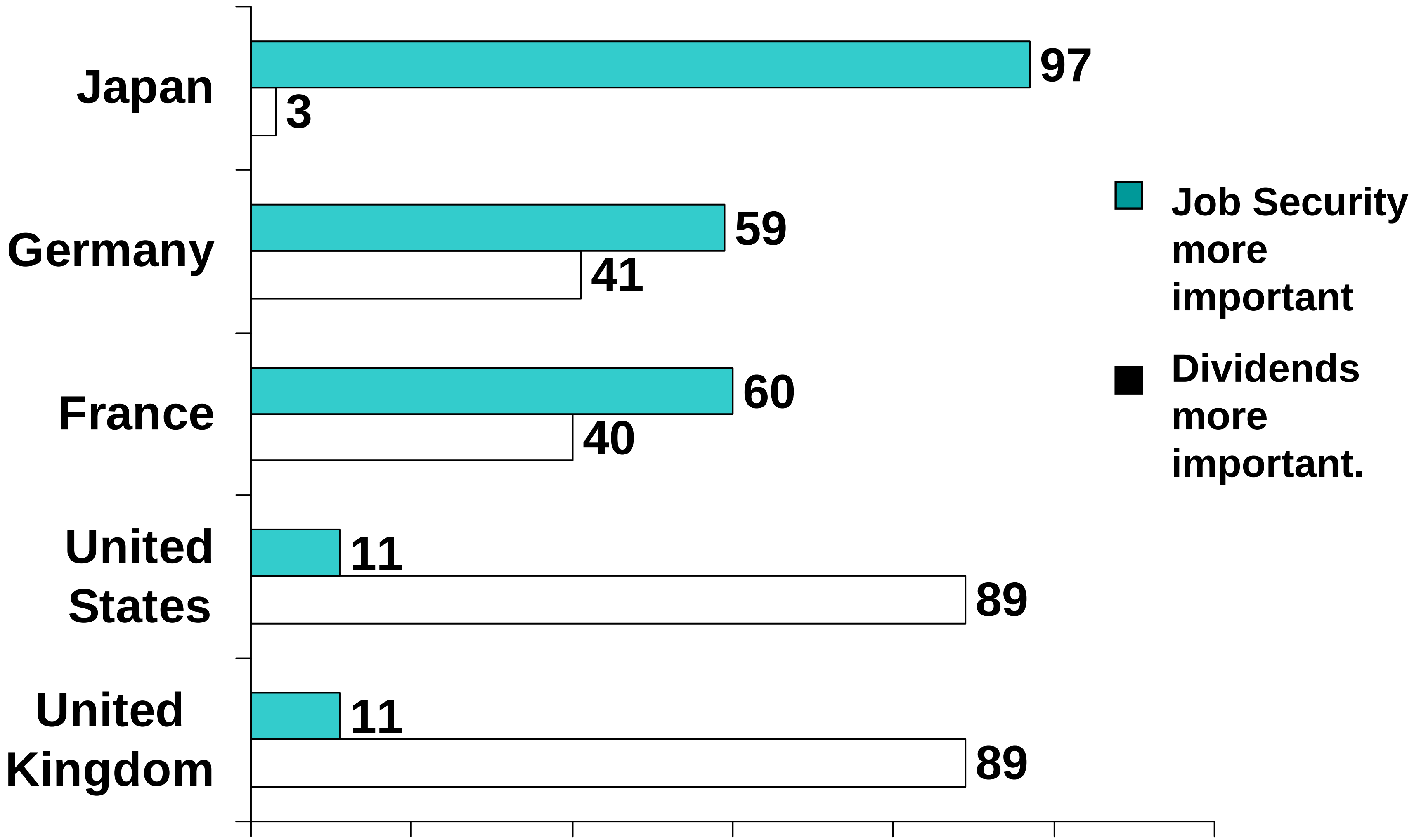
Survey of managers:

- Which of the following two would be the most prevalent view in your country?

(a) Executives should maintain dividend payments, even if they must lay off a number of employees

(b) Executives should maintain stable employment, even if they must reduce dividends

Job Security or Dividends?



How stable is the US economy relative to Japan?

- Japan stopped growing fast in the 1990’s but the economy did not have a long lasting deep recession

- How much of this was due to firms’ reluctance to lay off workers and of banks to call in loans?

- Now the US is in recession and firms are laying off many people - how strong will the feedback effects be?

Current policies – An assessment

Central banks and governments are concerned to get banks lending again and are spending huge amounts to “solve the problem”

- Fear of lending versus liquidity hoarding?
- Anticipation of deflation
- Better to temporarily nationalize the banks than current policies of providing capital injections

- Governments have been assuming that if only they can get the financial system to operate properly the problem will disappear
- But the issue of price uncertainty after the bursting of the bubble will remain and may take a long time to resolve (e.g. Japan’s 15 year adjustment of real estate prices)
- Current government policies will have little effect on this problem and may exacerbate it

Concluding remarks

- This crisis will probably not be over quickly – establishing the correct prices is likely to take some time
- It is important for governments to be fiscally conservative so they can provide basic safety nets such as unemployment insurance for the duration of the crisis
- A severe recession is better than a loss of confidence in the fiscal integrity of the state