Crises

Econ 4335 Lecture

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Plan for the lecture

- Build-up, bubbles, imbalances, leverage
- Crisis:Contagion,accelerators
- Clean-up
- prevention

Appendixes

- Typology, prevalence
- An example: The Kristiania Crash 1899
- Why so many banking crises? Risk factors
- The aftermath of banking crises
- Some aspects of the recent crisis

In separate file

Two kinds

- Abrupt and deep fall in prices of one or more asset classes (price collapses)
- Failure of one or more financial institutions
- Banking crises often coincide with deep falls in asset prices
- Asset price collapses coincide less often with banking crises
- Focus systemic banking crises

Vulnerable banks

- Low equity ratio
- Sells insurance against uninsurable events (macro uncertainty)
- Depend on trust

Rational bubbles or irrational exuberance?

Questions on rational bubbles:

1. Where do they come from?
2. Who coordinates opinions?
3. Who throws the dice?
4. What is the alternative?

Rational bubbles are irrational exuberance?

Questions on rational bubbles:

1. Where do they come from?
2. Who coordinates opinions?
3. Who throws the dice?
4. What is the alternative?

1. They have always been there
2. Nobody
3. Nobody knows
4. Behavioral theories

Behavioral theories

- Extrapolation bias
- Herding
- This time is different

Replicating actions that have been successful for others is often a good strategy outside of financial markets
Experience from stock markets

- Momentum trading can be profitable
- Buying value stocks can also be profitable

Abreu and Brunnermeier 2003

Lessons from bubble theory

Bubbels are more likely to arise and to survive if

- Interest rates are low
- Growth rate is high
- Asset takes time to reproduce
- Short-sale is impossible
- Investment can be made by borrowed money
- Decision maker cannot be made liable for all losses
- The cash flow from operations is positive

Imbalances

- No loans, no debt crisis
- Financing bubbles
- Elastic supply of loans
- Shortsighted consumers
- Ditto governments
- Developers that do not stop in time.

Triggers

- Increased interest rates
- Reduced income growth
- (Minor) News

Banks and bursts

Speeding up the fall:

- Margin loans and other toxic objects
- denying new loans or renewals
- Tighter haircuts

Banks triggering the crisis

Banking crisis next?

Banks may have

- bubble on its own books
- financed others who invested in the bubble
- bubble as collateral for loans financing other investments.
- lent to firms that produce new bubbles

Contagion

- lend to each other
- counterparties in countless transactions
- interbank market fragile
- trade financing, customers are interconnected
- revelation of losses in one bank infects the view of other banks

The Clean-up

- Losses should be recognizedand dealt with immediately
- Reestablish functioning banks quickly
- Lender of last resort
- Look forward, let bygones be bygones
  - avoid using public money to compensate investors
  - monetary policy should look forward
- Do not make unlimited commitments

Too big?

- Too big to fail
- Too interconnected to fail
- Too big to save

Pric bubbles early

How to recognize bubbles before they collapse?

Too much banking?

- Implicit subsidies, negative externalities?
- More risk to the rich?
- Tax and transfer system better adapted to the life cycle?
- Stop promoting self-ownership of homes?
- Make competition work in investment banking
- Narrow banking?
- Resurrect the real bills doctrine?

Supervision

- Capital requirements
- Liquidity requirements
- Stable deposits requirement