Mishkin ch.12: Financial Crises

• **Definitions:**
  - Common: Crisis = severe contraction. (Depression: Consumption decline>10%)
  - Financial crisis = crisis with financial frictions; inability of the financial system to handle asymmetric information.

• **Typical Dynamics in “Advanced” Economics**
  - Advanced => Public & private debts denominated in own fiat currency

• **Typical Dynamics in “Emerging Market” Economics**
  - Emerging => Most borrowing in foreign currency (dollar).
  - Extra stage: Currency crisis => Devaluation.

• Question: Can financial crises be avoided (or mitigated)?
Dynamics of Financial Crises in Advanced Economics

• Typical Sequence of Events:
  
• Stage 1: Trigger for decline
  (Many causes. Not always information based)

• Stage 2: Banking Crisis
  (Critical stage: Reduces capacity to process financial information)

• Stage 3: Debt Deflation
  (Not always – severe crises only)

• Key element: Vicious Cycle
  GDP decline => Asset values down
  => Less collateral => Less credit
  => More GDP decline
  *Challenge is to break the cycle*
Dynamics of Financial Crises in Emerging Economics

• Sequence of Events …

• New Stage: Currency crisis

  Devaluation re-values foreign currency debt (loss to debtors)
  • Firms net worth down => less credit
  • At banks: losses => cause for runs
  • Higher public debt => doubts about solvency => future taxes/inflation

• Currency & Banking Crises:
  • Banks often borrow in foreign currency
  => Bank crisis can trigger currency crisis, and vice versa => “Twin Crisis”
    (e.g. Asia 1997-98)
  • Note: Debt deflation not shown—may occur

[Notes on Mishkin Ch.12 - P.3]
Example 1: The Great Depression

Example 2: The Housing-Finance Crisis of 2007-09

• Housing “bubble” 1998-2006: weak lending standards; government subsidies.
• Defaults on mortgage-backed securities (MBS) when house prices stop rising
  => Collapse of financial institutions holding MBS
• Difference to Great Depression: Federal Reserve credit expansion. Deposit insurance; insurance for Money Market funds. No waves of defaults.
Example 3: The Asian Crisis of 1997-98

• Asia in the 1990s: Strong growth - view credit growth as positive/supportive
• Problems in Thailand: unregulated “shadow banks” borrowing in US dollars
  - July 1997: failure of several financial institutions. => Loss of confidence in the banking system => simultaneously:
    2. Banking crisis: Credit crunch for firms => Recession.
  - Vicious cycle: Devaluation/recession => reduced bank/firm net worth.

• Contagion to nearby countries with similar characteristics:
  - Fall of 1997: Phillipines, Indonesia, Malaysia, South Korea.
    Run on currencies & banks => Devaluation & credit crunch => Recession.

• End of crisis: IMF entering as lender of last resort – providing credit
  - Contribution to the next crisis: incentive to accumulate $-currency reserves
  => Source of easy credit for the U.S. in 1998-2007
Final Question: Can Financial Crises be avoided or mitigated?

- Mishkin’s Stage 1 = systemic weakness + shock hitting the weak spot.
  - Option: impose regulations to correct the weakness. (Shocks difficult to avoid)

- Problem #1: more robust systems are often less efficient
  Example: Bank regulation after the Great Depression => Pressure for deregulation.

- Problem #2: the political process is often part of the problem
  Example: U.S. support for housing – FNMA, Freddie Mac, FHA, mandatory low-income lending (CRA), mortgage interest deductions. Not resolved!

- Mitigation: much discussed but problematic – creates new problems
  Examples: Central bank as lender of last resort => Large banks Too-Big-To-Fail.
  Fiscal stimulus => Inefficient spending & rising government debt.