The Global Financial Crisis After One Year

Structural and Regional Impacts of Financial Crises

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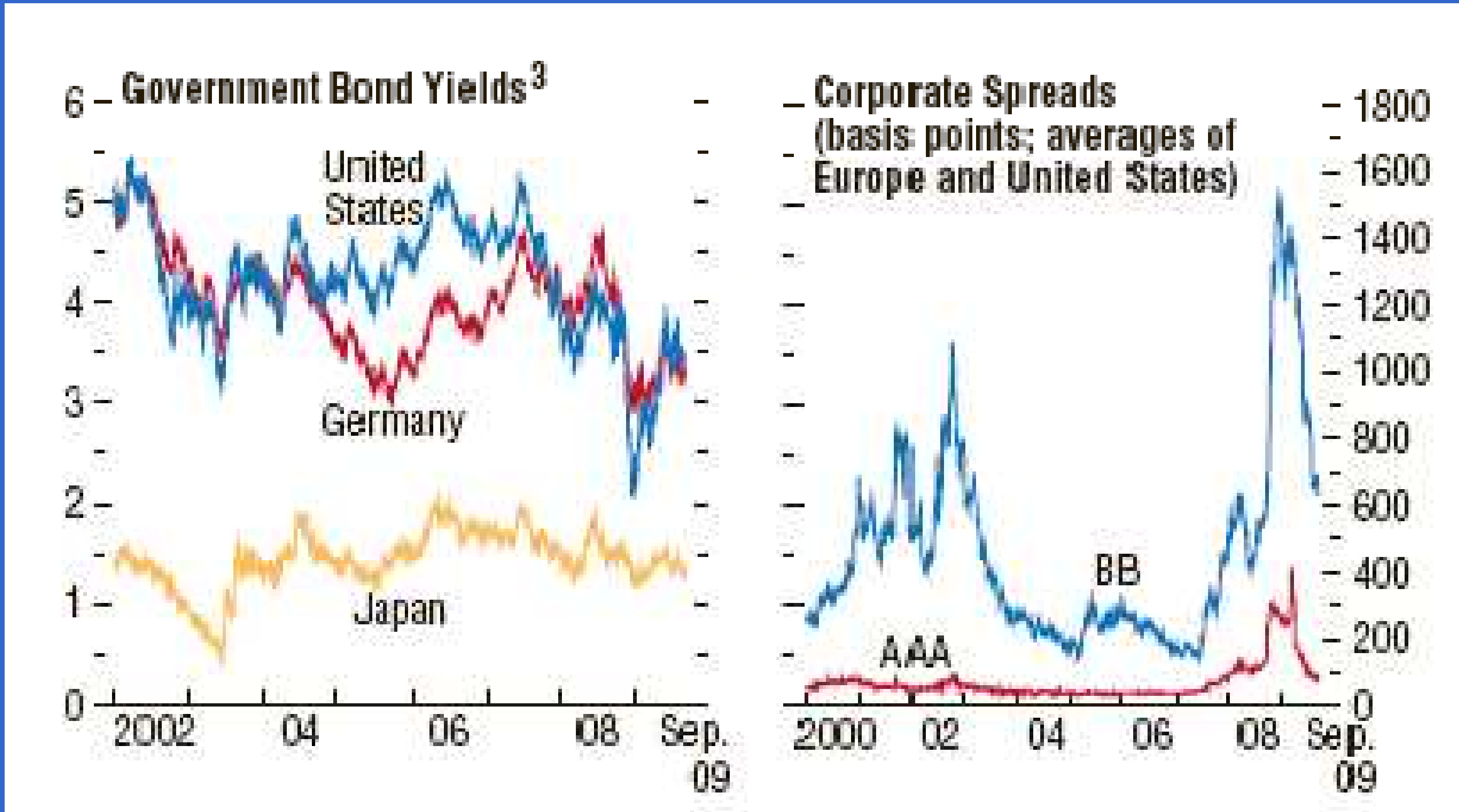
Averting Catastrophe

- Lehman collapsed, AIG almost collapsed
- US financial markets froze. Who was next?
- Huge increases in interest rate spreads

Interest Rate Spreads: Corporate over US Treasuries



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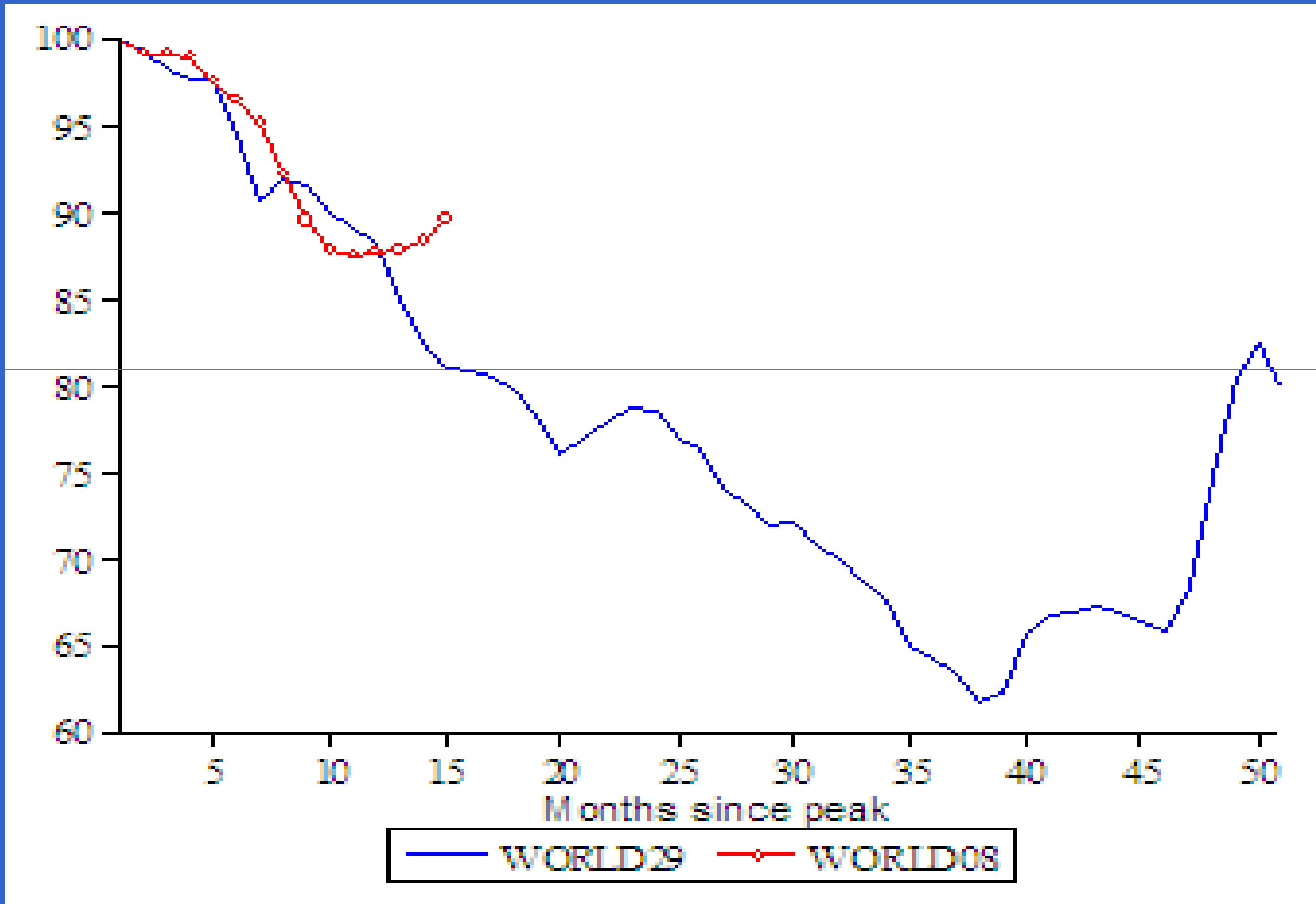
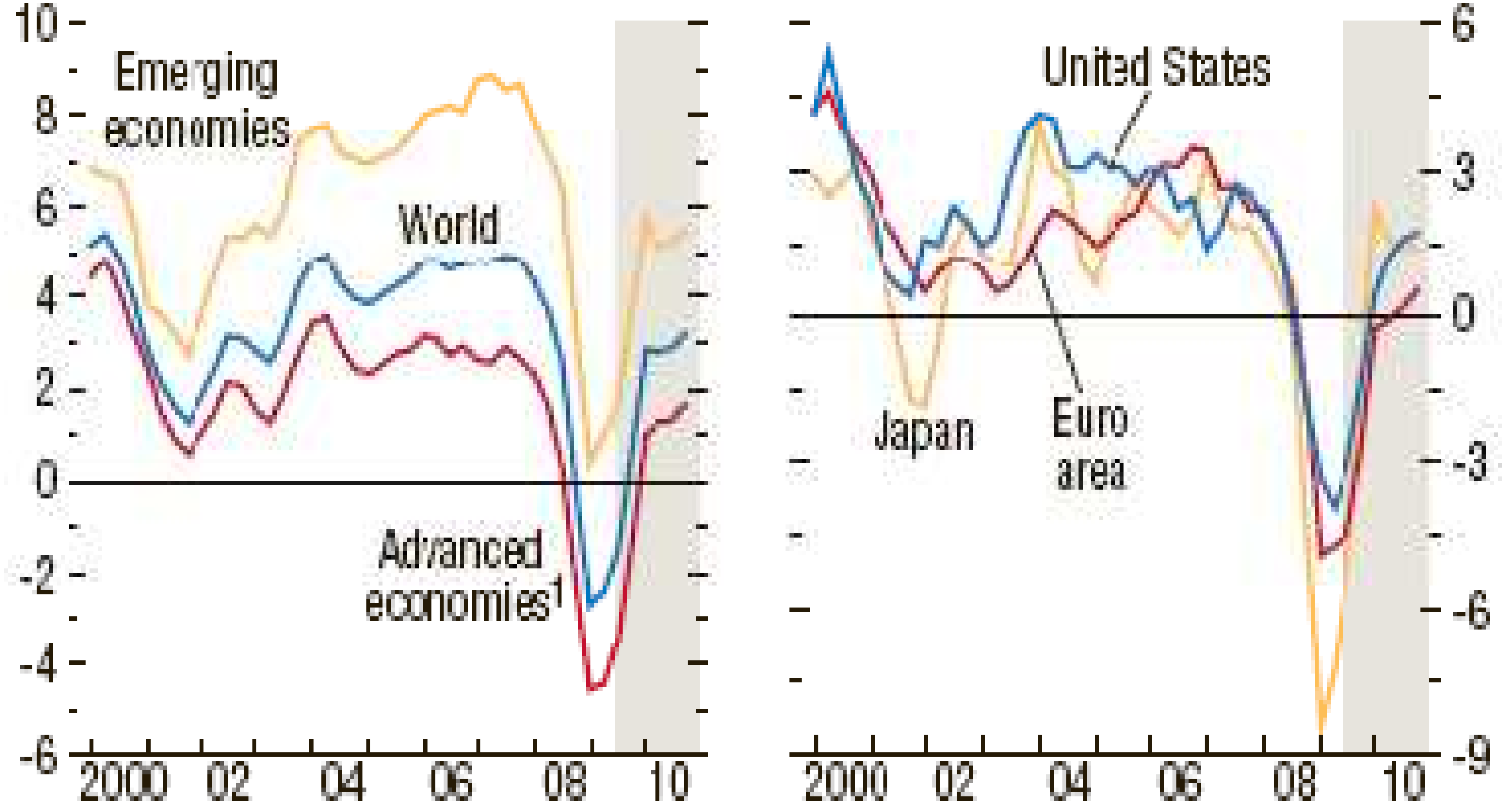
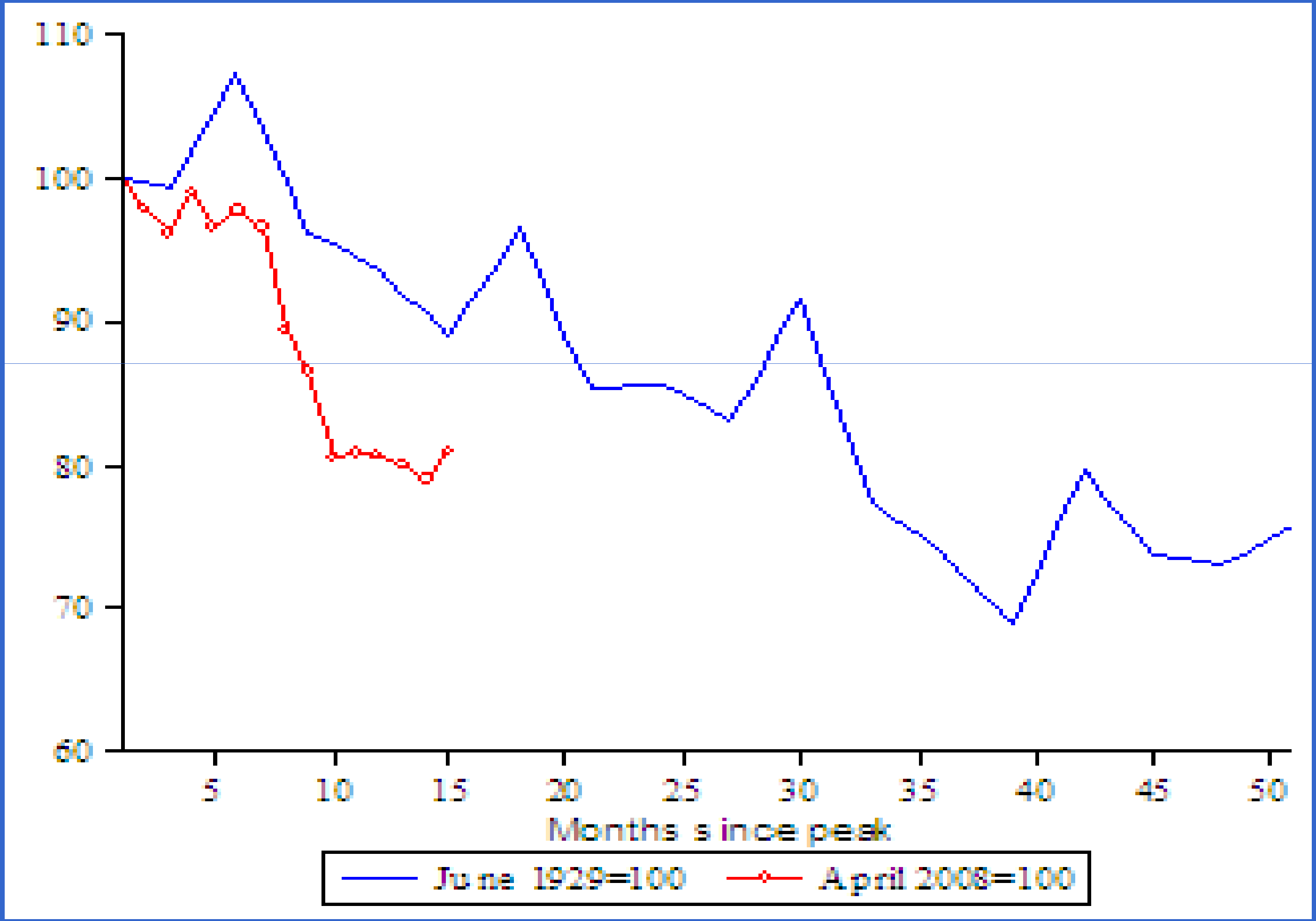
Industrial Production



Real GDP Growth



International Trade



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  - Industrial Production
  - GDP
  - International Trade

- Crisis began in US, spread worldwide
  - Contagion to countries with their own banking crises
    - Iceland
    - Hungary
    - Ukraine
  - Countries with housing bubbles
    - Baltics
    - Ireland
    - Spain
  - Commodity exporters
    - Russia
  - Credit squeeze for all borrowing countries
  - Trade effects everywhere

- Vigorous policy response in US and elsewhere averted another Depression
  - Money supply – huge increases worldwide
  - Enormous bank bailouts, deposit guarantees, but no nationalizations of big financial companies
  - Quantitative easing – innovative response to financial collapse
  - Nominal interest rate → 0
  - Fiscal stimulus
  - Swaps and loans to emerging markets

Is the Recovery Sustainable

- V shaped recoveries after steep US downturns are typical
  - Demand rebound led by spending on
    - Inventories
    - Equipment
    - Consumer durables
- This recession isn't typical
  - Not caused by Fed tightening to dampen inflation
  - Recoveries after banking crises are often U or L shaped

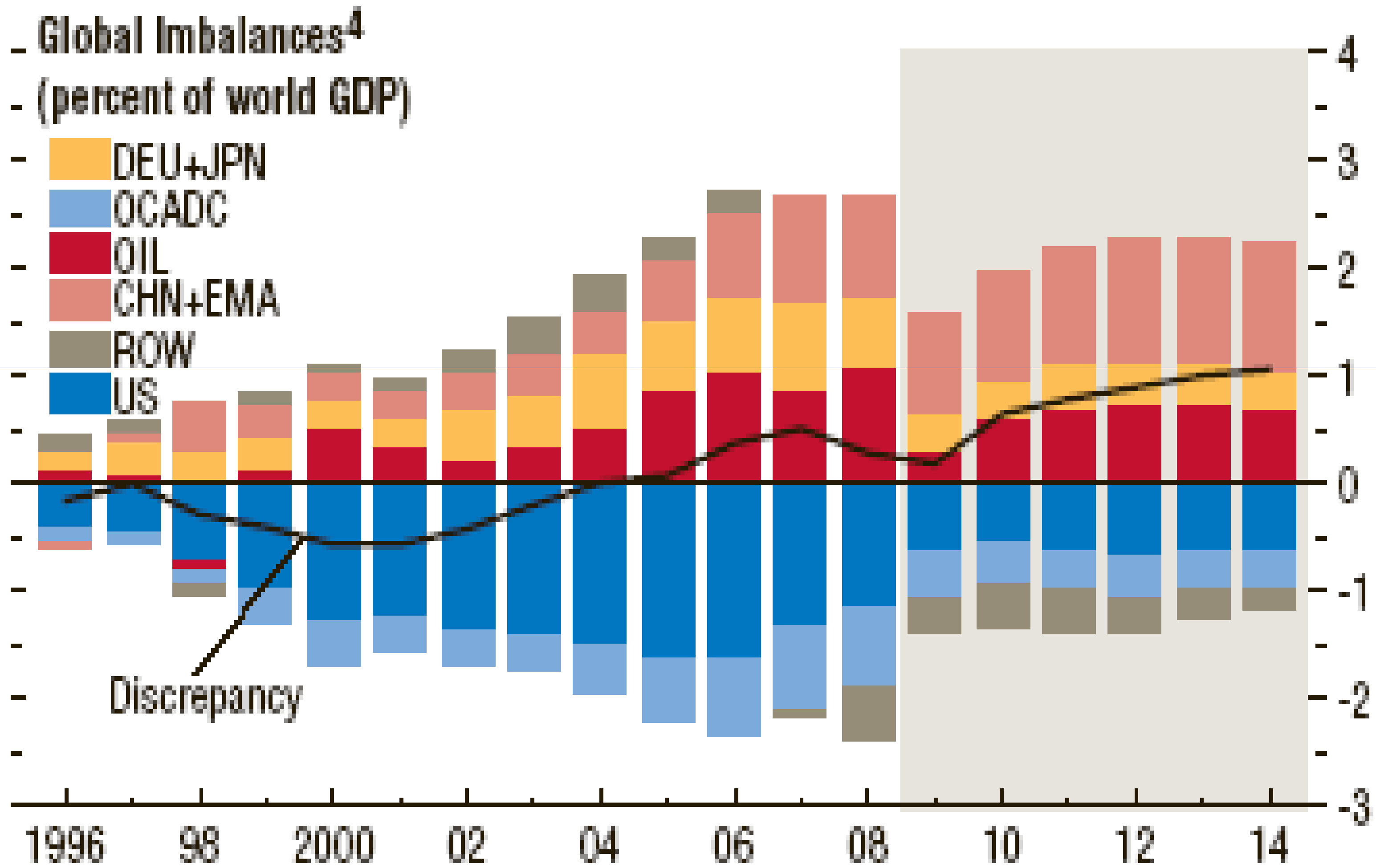
- Is this recovery like
  - Sweden
    - Nationalized large failed banks
    - Fired top executives
    - Wrote off bad loans
    - Quickly began making new loans
    - V shaped recovery
  - Japan
    - No government takeovers of major financial institutions
    - Few changes in top management
    - Zombie banks kept bad debt on their books
    - Little new lending
    - Decade of stagnation
    - L shaped recovery

- US
  - No large banks nationalized
  - Top management still in place
  - No big loan write-offs. Future problems with
    - Commercial real estate
    - Credit card debt, other household debt
  - Feeble bank lending
  - Upturn in profits all from trading, not lending
- Some European banks are also zombies

- Rebalancing
  - – Trade deficits for US and surpluses for China, Germany, Japan, and OPEC
    - Much smaller because of recession
    - Will rise again as world economy recovers
    - But not to pre-crisis levels
    - Will dollar stay low, fall further or rise?
  - – If US isn’t consumer of last resort,

    Who will be world growth engine
    - China is still too small
    - Japan and Germany are reluctant to spur consumption, reduce exports
    - Emerging market countries want large FX reserves
    - Oil exporters’ surpluses will rise as oil price rises

Current Account Balances



- When to tighten
  - No visible signs of inflation today
  - Taylor Rule says monetary policy is too tight
  - Eventually growth will return,

    inflation not deflation will be the threat
  - But tightening monetary policy with rising or high unemployment may be politically difficult
  - Enormous fiscal deficits aren’t just cyclical, hard to reduce to normal levels
  - Will US inflate to erode its debt?

Preventing the Next Crisis

- Should central banks use monetary policy to prevent or deflate bubbles
  - Politically difficult
  - Use regulations first
  - But maybe yes

- Increase capital requirements and liquidity ratios
  - Countercyclical capital requirements
  - For nonbank financial institutions too
  - Larger reserves for banks too big to fail
  - International cooperation to prevent regulatory arbitrage

- Corporate governance and compensation
  - Restrictions on compensation
    - Limit on total compensation
    - No bonuses for short term (1 year) performance
  - Separate corporate risk management dept
  - Separate board committee on risk

- Other tools
  - Variable margin requirements for buying equity to prevent another Internet bubble
  - Mortgage restrictions
    - Loan to value
    - ARMs and teaser rates
    - No NINJA loans
  - Off-balance-sheet lending
- Systemic or macro-prudential regulation
- Consumer protection in separate agency
- Derivatives
  - Move to exchanges, restrict over-the-counter
  - Require deposits or reserves

- Too big to fail
  - Re-impose Glass-Steagall. Break up
    - Commercial banks
    - Investment banks
    - Insurance companies
    - Brokerages
  - Break up large banks
  - Too big to bail.

    No large banks in small countries

Lessons from the US Experience

- Markets don’t always work, especially financial markets
- Tighter regulation required for
  - Very big institutions
  - Very interconnected institutions
  - Not just for commercial banks
- But their political power may prevent effective reform or enforcement
- Vigorous monetary and fiscal policy response needed during crises
- Large global imbalances are dangerous