

# **CHAPTER**

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# **Financial Crises, Panics, and Unconventional Monetary Policy**

# Chapter Goals

- Explain why financial crises are dangerous and why most economists see a role for the central bank as a lender of last resort.
- Explain the role of leverage and herding in financial bubbles and how central bank policy can contribute to a financial bubble.
- Explain why regulating the financial sector and preventing financial crises is so difficult.
- Discuss monetary policy in the post-financial crisis period.

# Financial Crises, Panics, and Unconventional Monetary Policy

In 2008, the world financial system nearly stopped working.

- Banks were on the verge of collapse.
- The stock market dropped precipitously.
- The U.S. economy fell into a serious recession.

Central banks and governments across the world took extraordinary steps to try and calm the crisis.

A highly unconventional monetary policy became the new normal.

# The Central Bank's Role in a Crises

A financial sector collapse would bring all other sectors crashing down.

As crisis hit, Fed put into play unprecedented actions.

Acting as a lender of last resort providing loans to financial institutions that were **solvent** or (having sufficient assets to cover their long-run liabilities) but were not sufficiently **liquid** (having assets that could readily be converted into cash and money at nonfire sale prices).

Fed provided liquidity to the financial market.

# The Central Bank's Role in a Crisis

All the other sectors need the financial sector to do business.

The fear in October 2008 was that the financial crisis on Wall Street would spread from Wall Street (the financial sector) to Main Street (the real sector), creating not a *recession* but a *depression*.

# Anatomy of a Financial Crisis

1. Creation of an **asset price bubble**, unsustainable rapidly rising prices of some type of asset.
2. The bubble bursts, causing a recession.
3. The effects of the bursting bubble threaten the entire financial system.
4. People cut spending.
5. Firms cut back even more, creating a downward spiral that can turn a recession into a depression.
6. Key to a bubble: **extrapolative expectations** – expectations that a trend will accelerate.

# The Financial Crisis: The Bubble Bursts

In 2005, housing prices started to level off and by 2006 housing prices began to fall precipitously.

There was a crisis in the market for **mortgage-backed securities** that are bundles of mortgages sold on the securities market.

The Fed engaged in financial triage – taking care of the most damaged banks with emergency measures.

# The Role of Leverage and Herding in a Crisis

**Leverage**—the practice of buying an asset with borrowed money.

Monetary policy can encourage the development of a bubble.

**Herding** is the human tendency to follow the crowd.

When people become convinced the price of an asset is going to rise, everyone buys more of it on credit, making the bubble larger.

# The Problem of Regulating the Financial Sector

Once the signs of a bubble were clear, why didn't economists warn society that a financial crisis was about to happen?

- Policy makers were swayed by political interests.
- There was more a failure of economic engineering and economic management than of economic science.
- Due to the **efficient market hypothesis**, policy makers didn't worry about the financial crisis.

The events of 2008 changed the view that markets are rational and ushered in the structural stagnation view.

# Regulation, Bubbles, and the Financial Sector

New financial regulation was established.

- **Deposit insurance** is a system under which the federal government promises to reimburse an individual for any losses due to bank failure.
- **Glass-Steagall Act** was passed in 1933 that created deposit insurance and prohibited commercial banks from investing in the securities market.

Any type of guarantee, or expectation of a bailout, can create a **moral hazard problem** – a problem that arises when people's actions do not reflect the full cost of their actions.

# The Law of Diminishing Control

The **law of diminishing control** holds that whenever a regulatory system is set up, individuals or firms being regulated will figure out ways to circumvent those regulations.

New financial institutions and instruments circumvented bank regulation.

Regulations covered fewer financial instruments.

- Undesirable financial practices simply moved outside the banking system and into other financial institutions.

# The Law of Diminishing Control

Political pressure to reduce regulations: When regulation successfully eliminates or reduces the problems, people begin to forget that the regulation was necessary in the first place.

Politics had to deal with the **too-big-too-fail problem**, an example of the moral hazard problem.

In an attempt to minimize the too-big-to fail problem, the U.S. passed the **Dodd-Frank Wall Street Reform and Consumer Protection Act**.

# General Principles of Regulation

Three general precepts about dealing with financial crises:

1. Set as few bad precedents as possible.
2. Deal with moral hazard.
3. Deal with the law of diminishing control.

# Monetary Policy in the Post-Financial Crisis Era

After the financial crisis subsided, the standard practice would have been for the Fed to wind down its lender-of-last resort loans.

It did not do that because the economy was in a deep recession.

If the problem facing the U.S. economy is a structural stagnation problem, a primary policy focus has to be on resolving the structural problems before expansionary monetary policy is called for.

# Monetary Policy in the Post-Financial Crisis Era

The Fed continued running expansionary monetary policy after the U.S. emerged from the financial crisis and the recession because three things occurred.

- 1) Inflation remained lower than desired.
- 2) Economic growth remained sluggish. During the upturn, growth was only 2 to 3 percent rather than the 5 to 6 percent they were hoping for.
- 3) There was a fear that ending the expansionary policy would throw the economy into a recession and possibly even another financial crisis.

# Unconventional Monetary Policies

The Fed created a new set of policies to stimulate the economy through unconventional means.

1. **Quantitative easing** is policy of buying a wide range of financial assets from banks and other financial institutions in order to stimulate the economy.
2. **Operation Twist** refers to selling short-term Treasury bills and buying long-term Treasury bonds without creating more new money; was meant to twist the yield curve by lowering long-term rates and raising short-term rates.
3. **Precommitment policy** involves the Fed committing to continue a policy for a prolonged period of time.

# Winding Down Unconventional Monetary Policy

Unconventional policies were seen as a temporary set of policies.

As inflation remained low, there was little pressure on the Fed to unwind its policies.

In 2017 Fed began to sell off some of its nontraditional assets as target rate was reached.

# Chapter Summary (1 of 3)

The financial sector provides the credit that all other sectors need for both day-to-day and long-term needs.

If the financial sector were to collapse, all other sectors would crash along with it.

The Fed has the resources and ability to lend to financial institutions and banks when no one else will.

The elements of a financial crisis are: (1) asset prices rise to unsustainable levels (a bubble develops), (2) asset prices fall precipitously (the bubble bursts), pushing the economy into a financial crisis, and (3) the economy falls into a severe recession.

# Chapter Summary (2 of 3)

Two ingredients of a bubble are herding and leveraging.

Government regulations that guarantee bailouts create the moral hazard problem.

Regulations have limited impact on bank behavior because of the law of diminishing control.

Because the failure of large banks would have disastrous effects on the real economy, they are considered too big to fail, which leads to the moral hazard problem.

## Chapter Summary (3 of 3)

Three general principles of regulation are: (1) set as few precedents as possible to limit the moral hazard problem, (2) deal with moral hazard by requiring banks to face the consequences of their actions, and (3) change regulations as innovations emerge and business practices change.

The Fed implemented unconventional policies such as quantitative easing, operation twist, and precommitment policy.