INTERMEDIATE MACROECONOMICS-II

B.A.(H) Economics, Semester-IV

Topic-3: Fiscal & Monetary Policy,
Lecture Notes-V
(Ref: Mishkin, *Macroeconomics*, Chapter-15)

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Financial Crises and the Economy

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- The recession that began in December 2007 worsened by the fall of 2008, leading to steep declines in economic activity. Check this **link** for a detailed explanation of the credit crisis.

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- The analysis of how asymmetric information problems can generate an adverse selection and moral hazard problems referred to as **agency theory**.
- A financial crisis occurs when an increase in asymmetric information from a disruption in the financial system prevents it from channeling funds efficiently.

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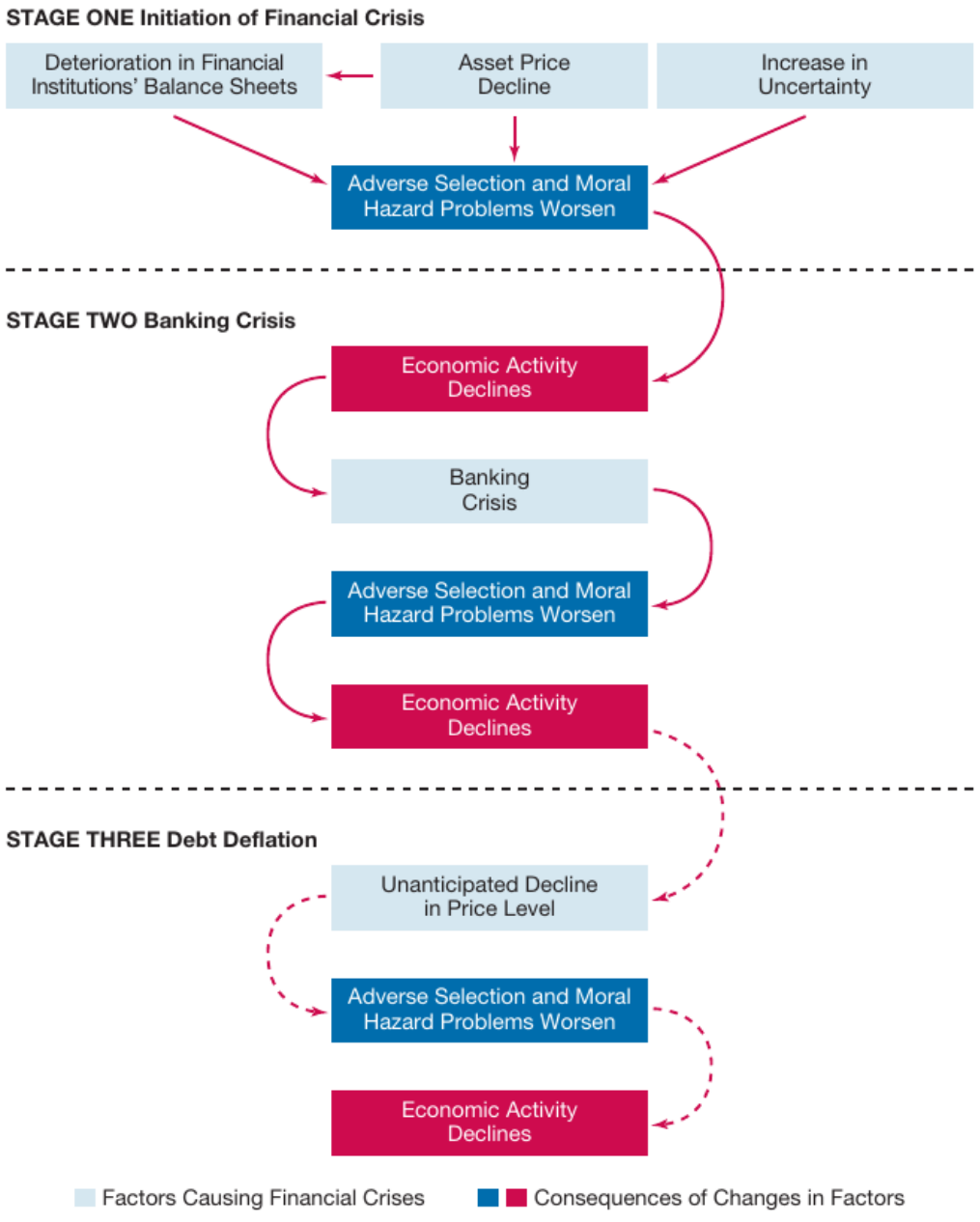
- The sections separated by the dashed horizontal lines, show the different stages of a financial crisis.


STAGE ONE Initiation of Financial Crisis
Deterioration in Financial Institutions' Balance Sheets
Asset Price Decline
Increase in Uncertainty
Adverse Selection and Moral Hazard Problems Worsen
STAGE TWO Banking Crisis
Economic Activity Declines
Banking Crisis
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STAGE THREE Debt Deflation
Unanticipated Decline in Price Level
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Factors Causing Financial Crises
Consequences of Changes in Factors

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  And when countries eliminate various restrictions on financial markets and institutions, this refers to as **financial liberalization**.
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- Credit booms lead to inefficient screening and monitoring associated with credit risks which leads to overly risky lending.
- Government safety nets such as deposit insurance increase the moral hazard incentive for banks to take on greater risk. Without proper monitoring, risk-taking both by lenders and borrowers grow unchecked.

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- Thus autonomous consumption expenditure and investment decline so that aggregate demand, $C + I + G + NX$, falls causing economic activity to contract.

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- The rise of asset prices above their fundamental economic values is an **asset-price bubble**, e.g. Tech stock market bubble (1990s), Housing price bubble(2007).
- Asset-price bubbles are often also driven by **credit booms**, in which the large increase in credit is used to fund purchases of assets, thereby driving up their price.

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- The asset-price bust also causes a decline in the value of financial institutions' assets, thereby causing a decline in their net worth, which causes them to deleverage, steepening the decline in aggregate demand and economic activity.

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- For example crises began after the failure of Ohio Life Insurance and Trust Company in 1857; the Jay Cooke and Company in 1873; Grant and Ward in 1884; the Knickerbocker Trust Company in 1907; the Bank of the United States in 1930; and Bear Stearns, Lehman Brothers, and AIG in 2008.

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- As few banks fail initially, then because of the asymmetric information, lender-savers can't find out whether their bank is a good bank or one of the insolvent ones.
- This encourages depositors (lender-savers) at bad and good banks to withdraw their money.

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- Increasingly severe adverse selection and moral hazard problems in financial markets deepen the financial crisis, causing declines in asset prices and the failure of firms throughout due to lack of funds.

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- Therefore, the borrowing firm's net worth in real terms (i.e. the difference between assets and liabilities in real terms) declines.
- This causes an increase in adverse selection and moral hazard problems facing lenders. Therefore, lending and economic activity decline for a long time.

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- This led to the stock market crash in October 1929, falling by 40% by the end of 1929.

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- Japan experienced a major banking crisis in 1992. And rather than shuttering insolvent banks and providing sufficient capital to surviving financial institutions, Japan followed a path of *regulatory forbearance*.
- The government permitted insolvent banks to artificially inflate the value of their assets so as to appear sound, valuing holdings of stocks at much higher historical levels.

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- The crisis subsided in 2003, when the Japanese government finally addressed its broken banking system.

Policy Response to Asset-Price Bubbles

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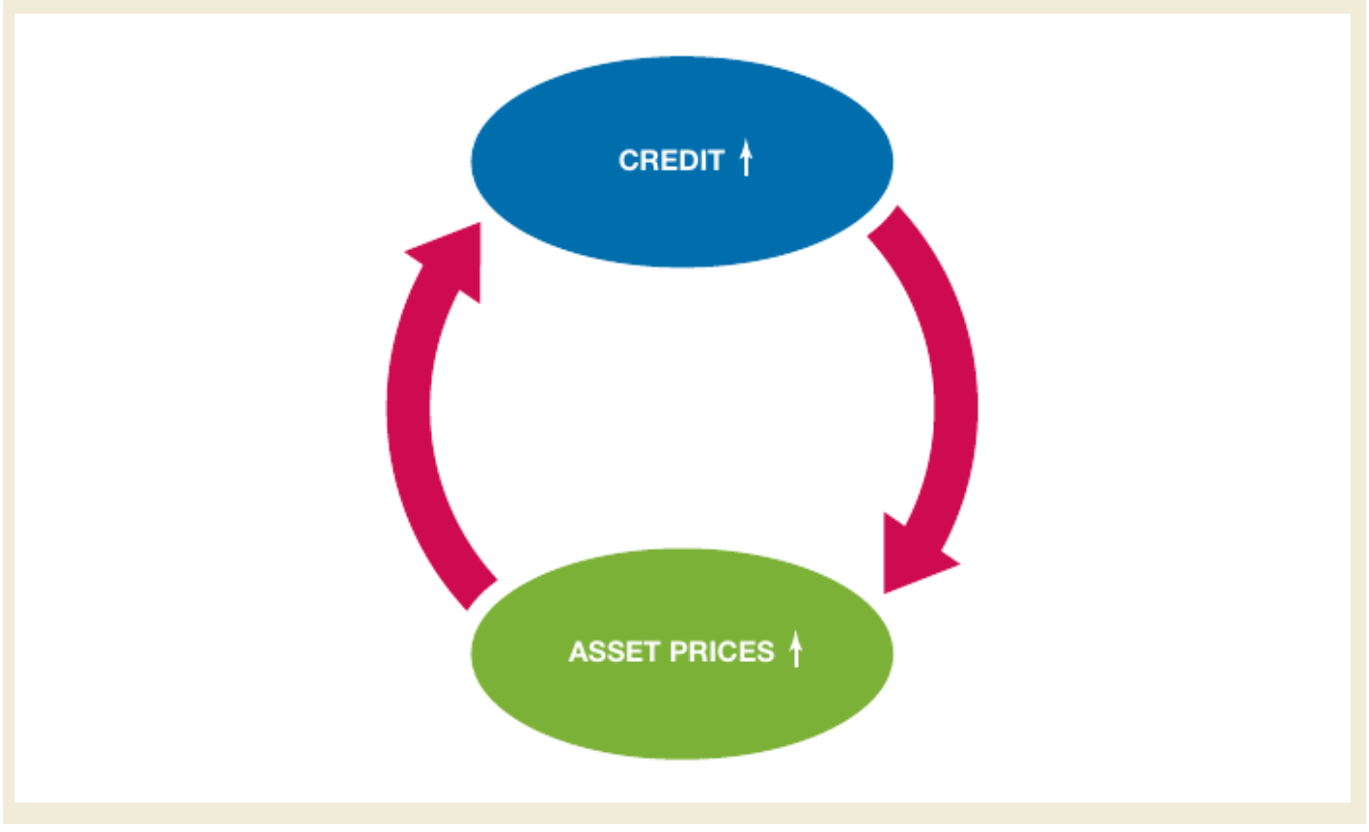
- When the bubble bursts, the collapse in asset prices then leads to a reversal of the feedback loop: loans go sour, lenders cut back on credit supply, the demand for assets declines further, and prices drop even more.

Feedback Loop Between Asset Prices and Credit

A credit boom drives up asset prices, which in turn further fuels the credit boom, driving asset prices higher, and so on.



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- For example, the bubble in technology stocks in the late 1990s was not fueled by credit, and the bursting of the tech-stock bubble did not deteriorate financial institutions' balance sheets.
- The bursting of the tech-stock bubble thus did not have a very severe impact on the economy and the recession that followed was quite mild.

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- In the aftermath of the 2007–2009 financial crisis, both central bankers and academic economists challenged the Fed's position, leading to an active debate on what central banks should do about asset-price bubbles.
- Economists argued that when asset-price bubbles are rising rapidly at the same time that credit is booming, there is a greater likelihood that asset prices are deviating from fundamentals.
- And in this case, central bank or government officials have a greater likelihood than market participants of identifying that a bubble is in progress.

- There are three strong arguments against using an autonomous tightening of monetary policy to pop credit-driven asset-price bubbles.
  (1) Higher real interest rates have highly uncertain effects on credit-driven asset- price bubbles. On the one hand, higher real interest rates can be ineffective in restraining the bubble when market participants continue to expect high rates of return from buying bubble-driven assets. On the other hand, if higher real interest rates succeed in bursting the bubble, it can unleash major damage on the economy, as occurred in 1929.

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  (2)The blunt tool of monetary policy tends to push many asset prices lower, even when a bubble may be present in only a small fraction of assets.
  (3)To prick a bubble, real interest rates might need to rise to such a high level that the decline in aggregate demand and the resulting economic contraction would create much hardship, as jobs are lost and inflation falls below a desirable level.

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- Financial regulation and supervision on an ongoing basis can prevent excessive risk-taking that can directly trigger a credit boom, which in turn leads to credit-driven asset-price bubbles.
- When a rapid rise in asset prices accompanied by a credit boom provides a signal that a bubble might be forming, central banks and other government regulators could then consider implementing policies to reign in credit growth directly or implement measures to make sure credit standards are sufficiently high.

Regulatory Policy Responses to Asset Bubbles

- Regulatory policy to affect what is happening in credit markets in the aggregate, referred to as **macroprudential regulation**.
- Financial regulation and supervision on an ongoing basis can prevent excessive risk-taking that can directly trigger a credit boom, which in turn leads to credit-driven asset-price bubbles.
- When a rapid rise in asset prices accompanied by a credit boom provides a signal that a bubble might be forming, central banks and other government regulators could then consider implementing policies to reign in credit growth directly or implement measures to make sure credit standards are sufficiently high.
- Appropriate macroprudential regulation can then help limit credit-driven bubbles and improve the performance of both the financial system and the economy.