

# Current Financial Crisis and Policy Responses

David E. Rapach

Department of Economics  
Saint Louis University

ECON 420 Money and Banking

December 8, 2008

# Importance of Financial Markets

- **Efficient** allocation of **scarce** financial capital
  - Important implications for **living standards**
  - Helps society attain optimal **risk-return** tradeoff
- Financial markets deal with **asymmetric information**
  - Adverse selection
  - Moral hazard
- Financial system adds economic value by processing information
  - Direct vs. indirect finance
- Breakdown of financial system potentially very costly to the **real economy**
- Getting regulation of the financial system right is crucial—and very challenging

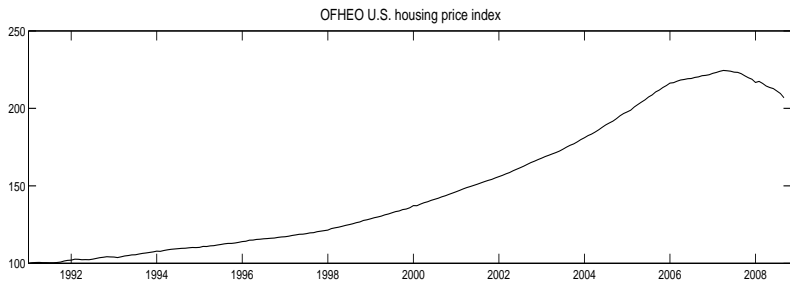
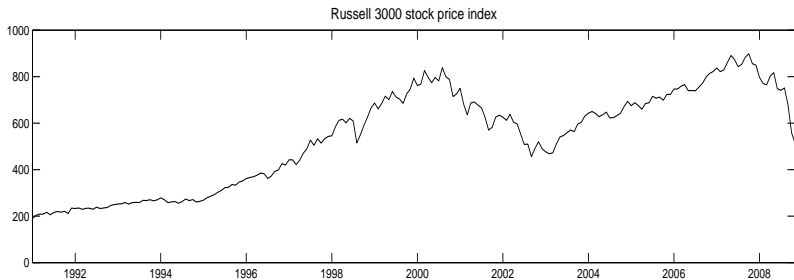
# What the Heck Happened?

- Financial innovation
  - Securitization: CDOs, especially MBOs (learn your acronyms!)
  - 'Originate and distribute' model
- Expansionary Fed monetary policy circa 2002–2006
  - Very low interest rates can prompt greater risk-taking
- Inadequate monitoring by regulators
- Housing market issues
  - Subprime/Alt-A mortgages
  - NINJA loans
  - Highly leveraged households/firms
- Systematic **mispricing of risk**
  - Bad assumption: housing prices would always rise
  - Insufficient regard for housing price **fundamentals**

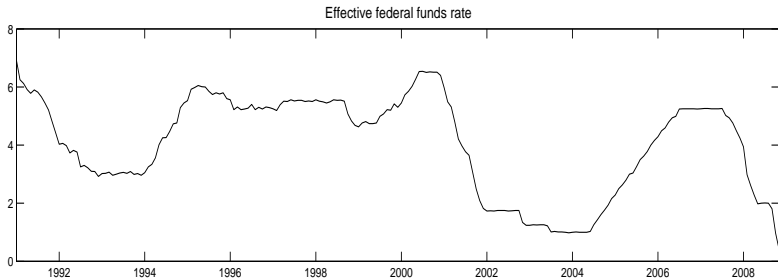
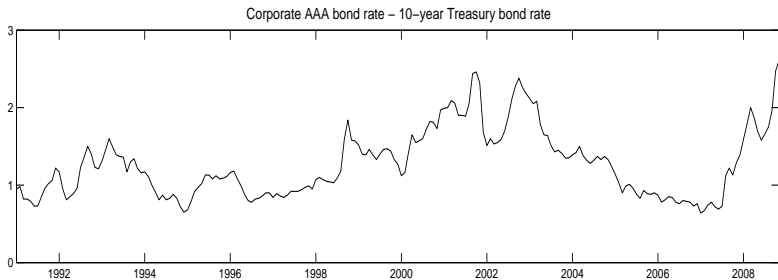
# What the Heck Happened?

- Housing price 'bubble' bursts
- Many financial markets 'lock up' due to ↑ in **uncertainty**
  - Pervasive/heightened asymmetric information concerns
  - Serious questions about asset quality
    - Especially difficult to ascertain quality due to securitization
  - Economic agents want to unload questionable assets
  - Many sellers/few (no?) willing buyers
  - Asset prices drop sharply, little trading takes place
- Elevated **risk premia** (depressed asset prices)
- Market prices less reliable/nonexistent
- Financial firms 'mark to market' and many appear insolvent
- Customers withdraw funds from questionable institutions
- Creates further problems due to **maturity mismatch**

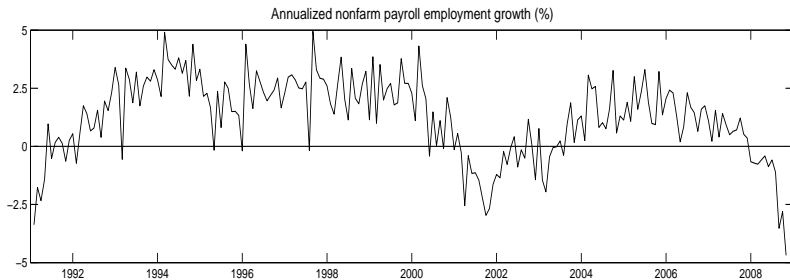
# Stock and Housing Prices



# Interest Rates



# Employment Statistics



# Policy Responses

- Federal Reserve (working overtime!)
  - Expansionary monetary policy to provide liquidity to financial system
  - Open discount window to additional parties in attempt to moderate uncertainty
    - TAF
    - TSLF
    - PDCF
  - Direct purchase of commercial paper, mortgages
  - Bottom line: Fed has drastically changed nature of assets on its balance sheet—now holds substantially **riskier** assets (see J.D. Hamilton, ‘The Federal Reserve’s Balance Sheet’)
- Treasury
  - TARP 1.0: purchase troubled assets (well, maybe not)
  - TARP 2.0: recapitalization of financial firms
- Mortgage help (SAM?)
- See L. Zingales, ‘Plan B’

# What's Next?

- What do you get when you cross an elephant with a rhinoceros?
- Short term
  - Recessionary outlook for the U.S./world economy
  - Continued Fed actions
  - Implement Treasury 'rescue' plan
  - Mortgage help?
- Long term
  - Expanded supervisory role for Fed
  - What about SEC and others?
  - Criteria for deciding who gets 'bailed out' in crises
  - Enhanced provision of information (accounting practices)
- We need to think very carefully about regulatory changes
  - Enhance stability without stifling innovation—very challenging