Lecture Review: Global Financial Crisis

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- Recession (biggest since the GD); increase in unemployment.
- International transmission through interconnected financial markets.

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Causes of the GFC

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  - When too many mortgages failed, the insurance companies could not pay out the CDS.

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  - Availability of MBS meant that mortgage originators could sell off their loans and not worry about defaults.
  - This led to a moral hazard problem where originators' revenue did not depend on the quality but rather the amount of loans.
  - Led to many loans made out to subprime borrowers who were at a greater risk of default.

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  - Reliance on credit rating agencies to gauge risks (who were paid by the banks to rate the MBS that banks were issuing).
  - Historically, very low default rates on mortgages.
  - Since mortgages were collateralised, some debt value could be recouped hence considered safer.

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Policy response to the GFC

- Financial bailouts for "Too Big To Fail" (TBTF) institutions.

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- Discount window lending for banks.
- Troubled Asset Relief Program (TARP) passed to purchase troubled companies' assets and stock.