



# Financial Crisis

What is a financial crisis?

- ▶ bank failure; loss of confidence in financial markets; reluctance of banks to lend.
- ▶ leads to a substantial contraction in economic activity.
- ▶ Eg; GFC, Great Depression, Asian Financial Crisis, Sovereign Debt Crisis (Greek).



# Financial Crisis

Stages of a financial crisis

- ▶ **Stage 1:** Easy Credit and Asset Price Bubbles
- ▶ **Stage 2:** Banking Crisis
- ▶ **Stage 3:** Debt Deflation



# Financial Crisis

Policies to address a financial crisis?

- ▶ **Monetary Policy:** reduce nominal interest rates, ease access of credit.
- ▶ **Fiscal policy:** increase government spending, reduce taxes.
- ▶ Unconventional monetary policy: quantitative easing.
- ▶ Financial bailouts to troubled sectors and banks.
- ▶ Modifications in prudential regulations.
- ▶ Greater international cooperation on macro policies and bank regulation.



# Great Depression

## Stock Market Bubble and Bust

- ▶ Innovation in the economy led to higher profits.
- ▶ Margin lending and increase in leverage possible due to financial innovation.
- ▶ Excessive optimism led to huge speculation on stock prices.
- ▶ Wall Street Crash of October 1929 (Great Crash).



# Great Depression

## Bank Failures, Money Supply, and Deflation

- ▶ Large number of bank failures in the 1930s in the USA and then worldwide.
- ▶ Bank regulation had size restrictions; small banks were not as robust/stable.
- ▶ Initial bank failures led to erosion in belief over stability of other banks.
- ▶ Bank runs and lower deposits led to contractions in the money supply.



# Great Depression

## International Transmission of the Great Depression

- ▶ In Australia, only 3 banks failed as a result but decline in GDP was similar to the USA.
- ▶ Gold Standard was a major factor in the transmission of the Great Depression.