Global Financial Crisis

What happened during the GFC?

- ▶ Housing market boom and bust in the US.
- ▶ Problems in the financial sector; bank failures.
- ▶ Recession (biggest since the GD); increase in unemployment.
- ▶ International transmission through interconnected financial markets.

Causes of the GFC

- ▶ Problems borne from financial innovation
    - ▶ Securitisation; MBS; Credit Default Swaps (CDS)
    - ▶ Securitisation: process of pooling assets to create an interest-bearing security.
    - ▶ MBS: mortgage-backed security; a security whose cash flows are derived from a pool of mortgages.
    - ▶ Credit Default Swaps are essentially insurance on the payment stream of a security.
    - ▶ Big insurance companies like AIG sold many CDS on MBS assuming they were extremely safe assets.
    - ▶ You did not need to own a MBS to buy a CDS on it!
    - ▶ When too many mortgages failed, the insurance companies could not pay out the CDS.

Causes of the GFC

- ▶ Moral hazard for home mortgage originators
    - ▶ 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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Causes of the GFC

- ▶ Investors systematically underestimated risks from MBS
    - ▶ 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.
- ▶ Short term nominal interest rates cut to zero.
- ▶ Quantitative easing to discipline long term interest rates, maintain liquidity, and stabilise troubled assets.
- ▶ Discount window lending for banks.
- ▶ Troubled Asset Relief Program (TARP) passed to purchase troubled companies' assets and stock.