

Monetary and Fiscal Policy during Crisis



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Outline

- Causes of Financial Crisis
- Effects of Financial Crisis
- Monetary Policy during Crisis
- Fiscal Policy during Crisis

Types of Financial Crisis

- Banking crisis
- Speculative bubbles and crashes
- International financial crises
- Wider economic crises

Financial Crisis

- ❑ The term financial crisis is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value.
- ❑ banking panics, recessions ,stock market crashes , the bursting of other financial bubbles, currency crisis, and sovereign defaults

Banking Crisis

- ❑ **bank run**: when a commercial bank suffers a sudden rush of withdrawals by depositors, this is called a bank run.
- ❑ **banking panic**: a situation in which bank runs are widespread is called a systemic banking crisis or just a banking panic.
- ❑ **credit crunch**: a situation without widespread bank runs, but in which banks are reluctant to lend, because they worry that they have insufficient funds available, is often called a credit crunch.

Speculative bubbles and crashes

- Economists say that a financial asset (stock, for example) exhibits a bubble when its price exceeds the value of the future income (such as interest or dividends) that would be received by owning it to maturity.

International financial crises

- When a country that maintains a fixed exchange rate is suddenly forced to devalue its currency because of a speculative attack, this is called a currency crisis or balance of payments crisis.

Wider economic crises

- **recession:** A downturn in economic growth lasting several quarters or more is usually called a recession
- **depression:** An especially prolonged recession may be called a depression
- **economic stagnation:** a long period of slow but not necessarily negative growth is sometimes called economic stagnation

Causes of Financial Crisis

- **Leverage:** borrowing to finance investments, is frequently cited as a contributor to financial crises
- **Asset-liability mismatch:** asset-liability mismatch, a situation in which the risks associated with an institution's debts and assets are not appropriately aligned

Causes of Financial Crisis

- **Regulatory failures:** failures of making sure institutions have sufficient assets to meet their contractual obligations, through reserve requirements, capital requirements, and other limits on leverage
- **Fraud:** companies have attracted depositors with misleading claims about their investment strategies, or have embezzled the resulting income



Specific Analysis of Subprime Mortgage Crisis

The subprime mortgage crisis is an ongoing financial crisis triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States, with major adverse consequences for banks and financial markets around the globe.

Specific Analysis of Subprime Mortgage Crisis

In its "Declaration of the Summit on Financial Markets and the World Economy," dated 15 November 2008, leaders of the Group of 20 cited the following causes:

"During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. (Market Investing Exuberance)

At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions." (Series of Regulatory Failure)

Boom and bust in the housing market

- ❑ Low interest rates and large inflows of foreign funds created easy credit conditions for a number of years prior to the crisis.
- ❑ The USA home ownership rate increased from 64% in 1994 (about where it had been since 1980) to an all-time high of 69.2% in 2004.

Boom and bust in the housing market

- ❑ This credit and house price explosion led to a building boom and a surplus of unsold homes.
- ❑ Adjustable-rate mortgages (ARM) enticed borrowers with a below market interest rate for some predetermined period, followed by market interest rates for the remainder of the mortgage's term.

Boom and bust in the housing market

- American households have spent more than their disposable personal income in every year starting in 1999.
- Household debt grew from \$705 billion at year-end 1974, 60% of disposable personal income, to \$7.4 trillion at yearend 2000, and finally to \$14.5 trillion in midyear 2008, 134% of disposable personal income. During 2008, the typical USA household owned 13 credit cards, with 40% of households carrying a balance, up from 6% in 1970.

Boom and bust in the housing market

- ❑ Borrowers in this situation have an incentive to "walk away" from their mortgages and abandon their homes, even though doing so will damage their credit rating for a number of years
- ❑ As more borrowers stop paying their mortgage payments, foreclosures and the supply of homes for sale increase. This places downward pressure on housing prices, which further lowers homeowners' equity. The decline in mortgage payments also reduces the value of mortgage-backed securities, which erodes the net worth and financial health of banks

Speculation

- During 2006, 22% of homes purchased (1.65 million units) were for investment purposes, with an additional 14% (1.07 million units) purchased as vacation homes.
- Economist Robert Shiller argues that speculative bubbles are fueled by *"contagious optimism, seemingly impervious to facts, that often takes hold when prices are rising. "*

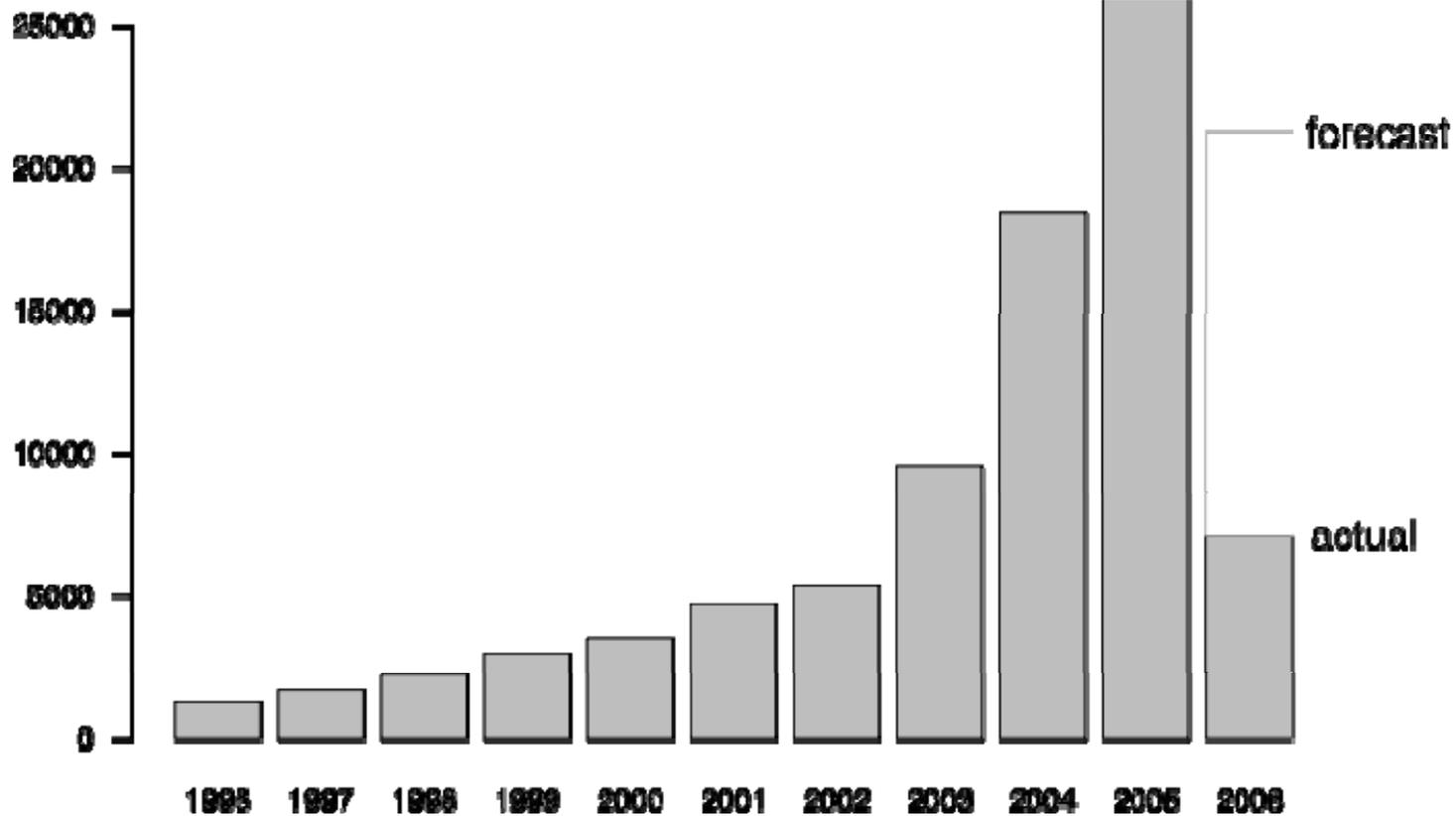
Speculation

- ❑ **The "hedge borrower,"** who expects to make debt payments from cash flows from other investments;
- ❑ **The "speculative borrower,"** who borrows believing that he can service the interest on his loan, but who must continually roll over the principal into new investments;
- ❑ **The "Ponzi borrower,"** who relies on the appreciation of the value of his assets to refinance or pay off his debt, while being unable to repay the original loan.
- ❑ *Speculative borrowing has been cited as a contributing factor to the subprime mortgage crisis.*

High-risk mortgage loans and lending/borrowing practices

- lenders began to offer more and more loans to higher-risk borrowers, including illegal immigrants. Subprime mortgages amounted to \$35 billion (5% of total originations) in 1994, 9% in 1996, \$160 billion (13%) in 1999, and \$600 billion (20%) in 2006

Growth in mortgage loan fraud



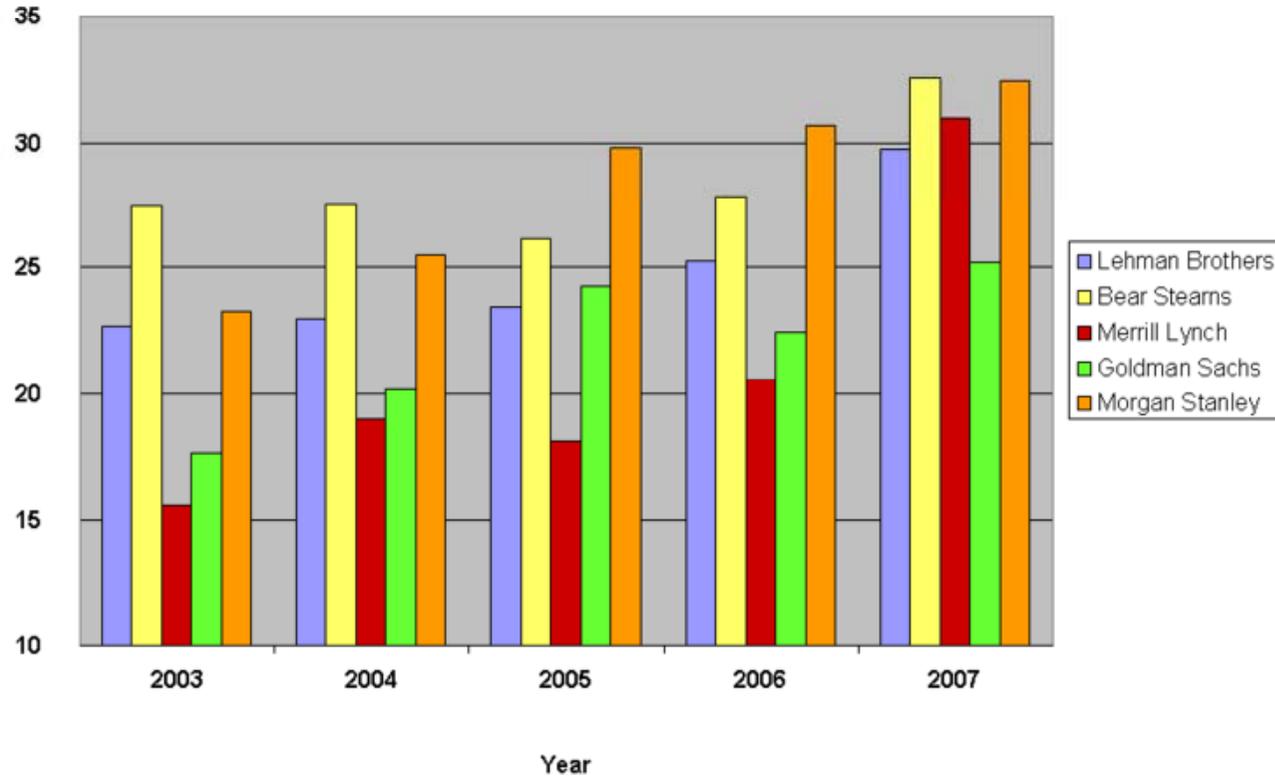
Inaccurate credit ratings

- ❑ There are indications that some involved in rating subprime-related securities knew at the time that the rating process was faulty
- ❑ rating agencies suffered from conflicts of interest, as they were paid by investment banks and other firms that organize and sell structured securities to investors

Financial institution debt levels and incentives

Leverage Ratios For Major Investment Banks

The leverage ratio is a measure of the risk taken by a firm; a higher ratio indicates more risk. It is calculated as total debt divided by stockholders equity. Each firm's ratio increased between 2003-2007.



Source Data: Company Annual Reports (SEC Form 10K)

Timeline of events

Background

Financialization (general evolutions in the area of finance which preceded the crisis)

Subprime mortgage crisis

Systemic risk

Events of 2007

Liquidity crisis emerges August 9, 2007

Northern Rock sought and received a liquidity support facility from the Bank of England on September 14, 2007

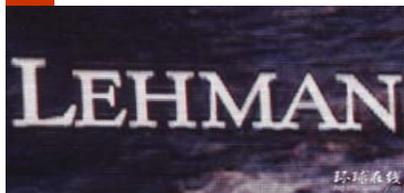
Record high US stock market October 9, 2007 Dow Jones Industrial Average (DJIA)
14,164

Events of 2008

- January 2008 stock market volatility
- On February 22, 2008 Northern Rock was taken into state ownership
- Bear Stearns (takeover in March)
- Federal takeover of Fannie Mae and Freddie Mac
- Global financial crisis of September–October 2008 (beginning with the Bankruptcy of Lehman Brothers)
 - Large losses in financial markets world wide throughout September and October
 - Emergency Economic Stabilization Act of 2008 passed
 - The three major banks of Iceland are nationalized. Banks in several other countries partially nationalized
 - China creates a stimulus plan in November
- US stock market November 20, 2008 Dow Jones Industrial Average (DJIA) 7,507
- The Australian Government injects 'economic stimulus package' to avoid the country going into recession, December, 2008

Bankruptcy

- Bankruptcy of **Lehman Brothers**
- Acquisition of **Merrill Lynch**
- Takeover of **Bear Stearns**
- “Nationalization” of **Morgan Stanley** and **Goldman Sachs**
- Fannie Mae and Freddie Mac Citibank
American Bank AIG



Hoarding Cash

Panic in financial market

No lending

lending only at very high rates

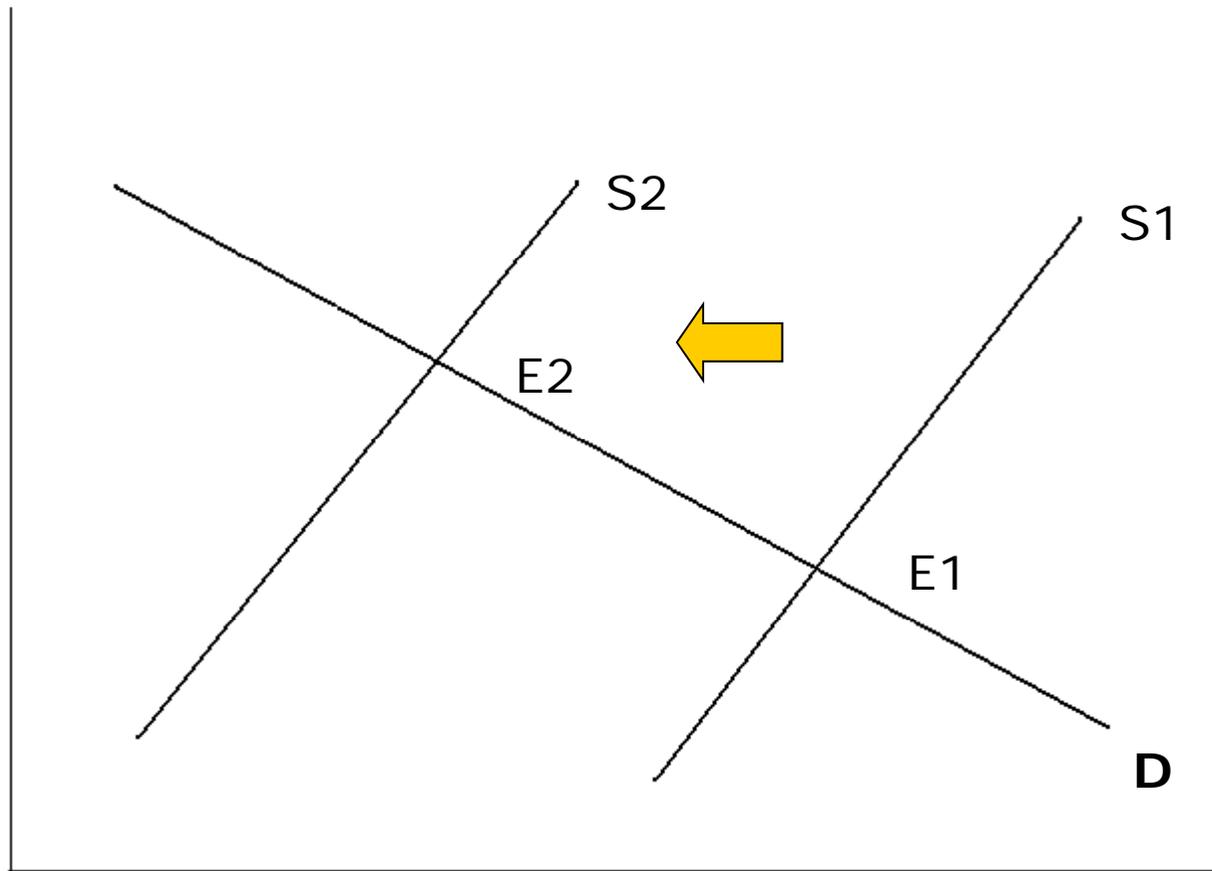
Banks are losing money on their funding

Higher borrowing rates for banks means
higher rates for everyone else

the World's Financial Plumbing is Gummed Up

Loanable Market

Real Interest
Rate

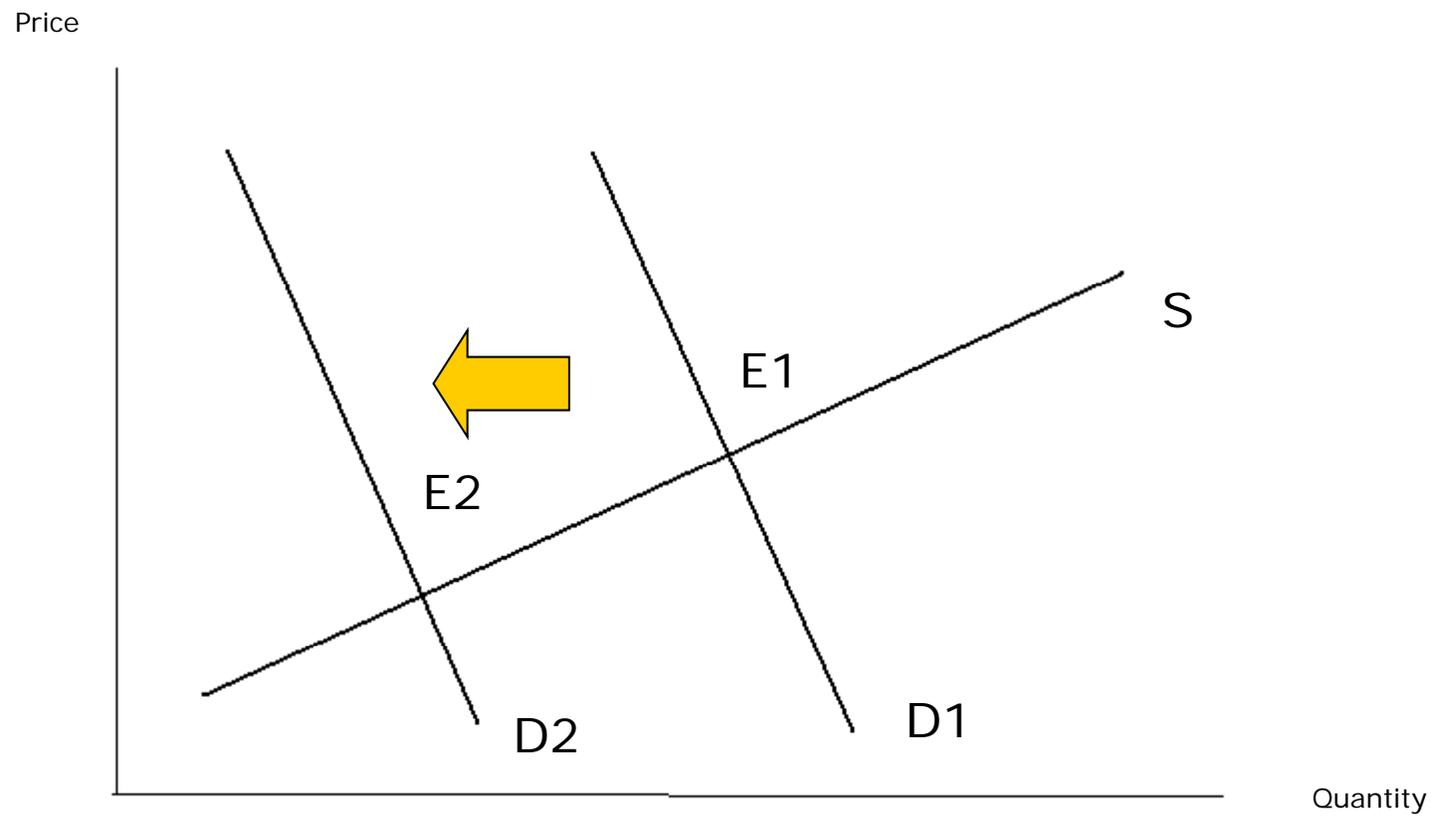


Quantity of Loanable Funds

Consumers dig in a length downturn

Nearly half of people surveyed said they were trying to save money by cutting back on “out of home” entertainment, such as going out to restaurants, and spending less money on new clothing, while more than one third were switching to cheaper grocery brands.

Market of Goods and Services



Think them over

- ❑ What will happen to an economy if investment and saving is cut down ?
- ❑ What will happen if the quantity of demand of goods and services is cutting down?
- ❑ What will happen to the global economy if free trade is limited ?

Economy Crisis from Fictitious Economy to Real Economy

- ❑ Auto Industry: The first to be infected
- ❑ IT: Farewell, My Golden Time!
- ❑ Retail Market: A Horrible Shopping Holiday
- ❑ Aviation Industry : Loss is Increasing
- ❑ Real Estate Market: Heavy Burdens
- ❑ Energy Resources: Decreasing Demand
- ❑ Entertainment Industry: Hard to Have Fun
- ❑ Sports: NBA Cutting Jobs

Cutbacks in personnel

- ❑ Choice of undergraduates
- ❑ Riots around the world



Summary

- ❑ Social turmoil
- ❑ Regulation of the national economy
- ❑ Coup?War?
- ❑ Revolution in Economics
- ❑ Changes in life style and people's mental world

Supplement-To pay close attention to
the long term impact of subprime
crisis on EA



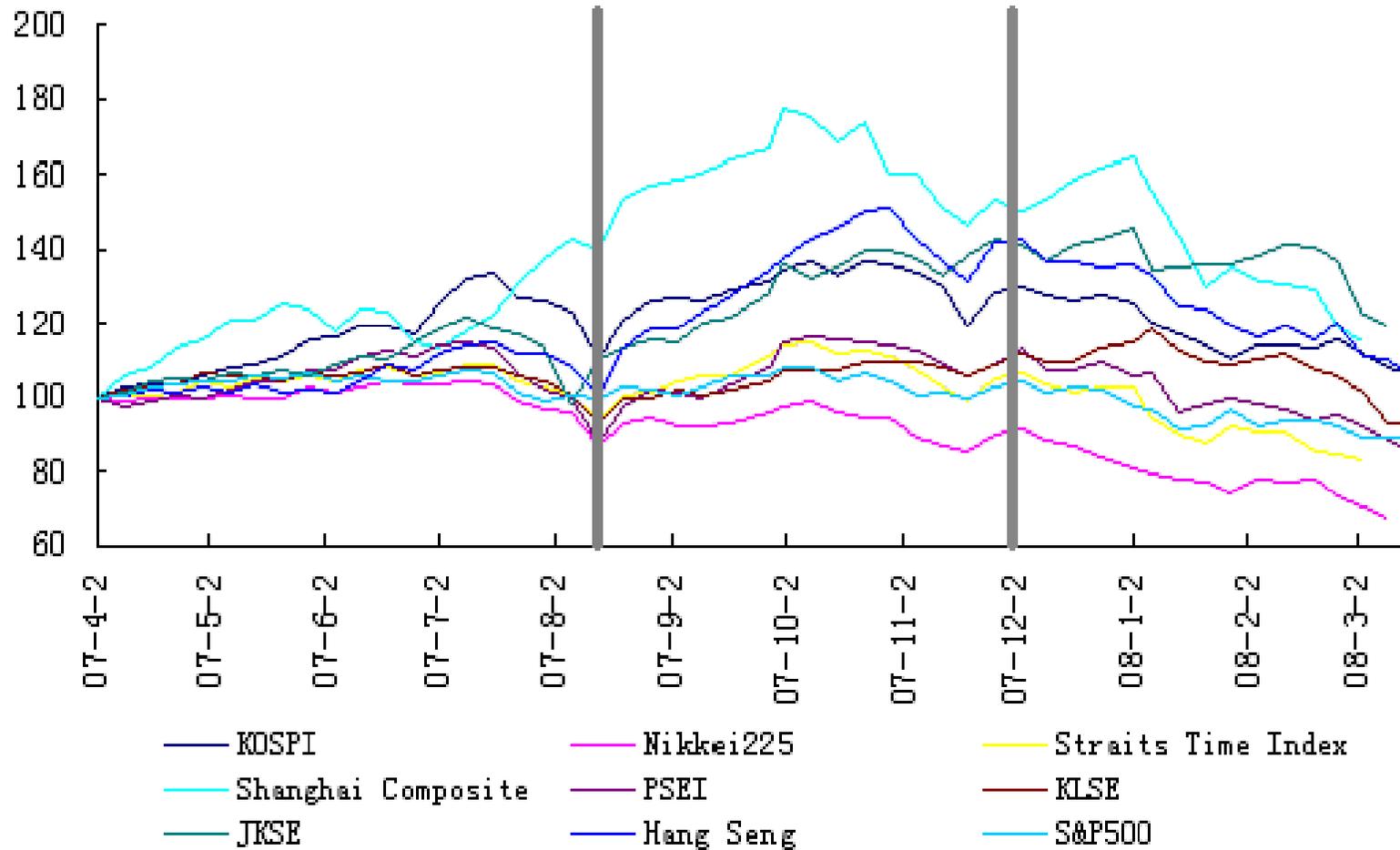
Financial institutions suffer losses

The Total Reported Losses of Asian banks (excepting Japan) is 11 billion. The estimated losses on other assets may be 30 billion.

Expected Bank Losses as of March 2008

IMF Global Financial Stability Report (GFSR)

Market fluctuation and the early crashed bubbles



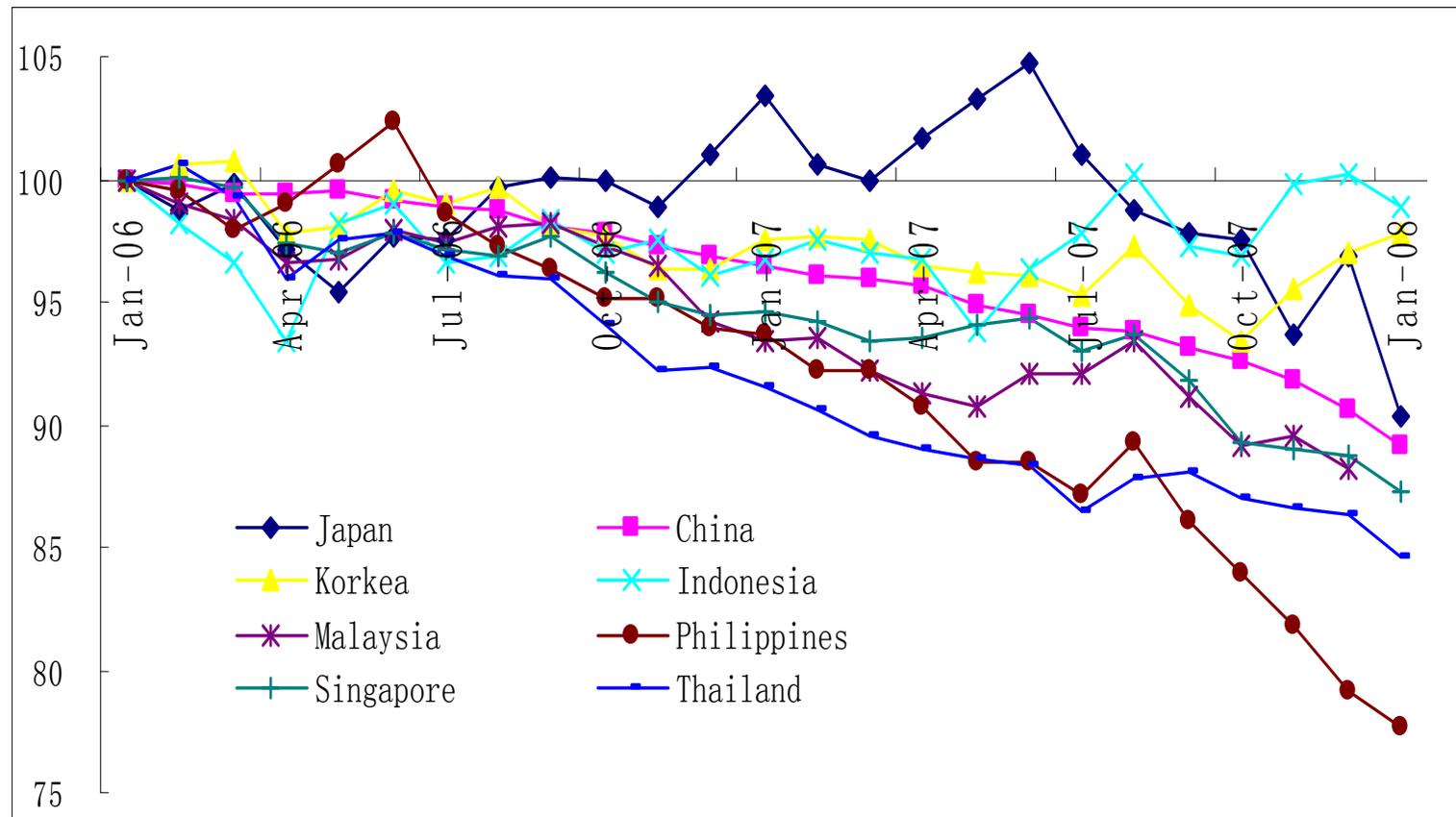
East Asian stock markets falling more than NYSE

	The stock index (9 April, 2008)	falling rate from the highest index (since 2 April, 2007) , %
KOSPI	1754.71	15.02
Nikkei 225	13111.89	20.06
HSE	23984	24.19
JKSE	2180.09	22.97
KLSE	1227.74	19.03
Shanghai Composite	3413.91	43.96
PSEI	2961.78	23.54
S & P 500	1354.49	13.46

The growth of economy may be slower

- ❑ The appreciation of the exchange rate of local currencies against USD and the recession of US and EU are challenges to export
- ❑ The price of Oil and other resources are pushing the inflation in EA
- ❑ The relax monetary policy make the monetary policy operation difficult

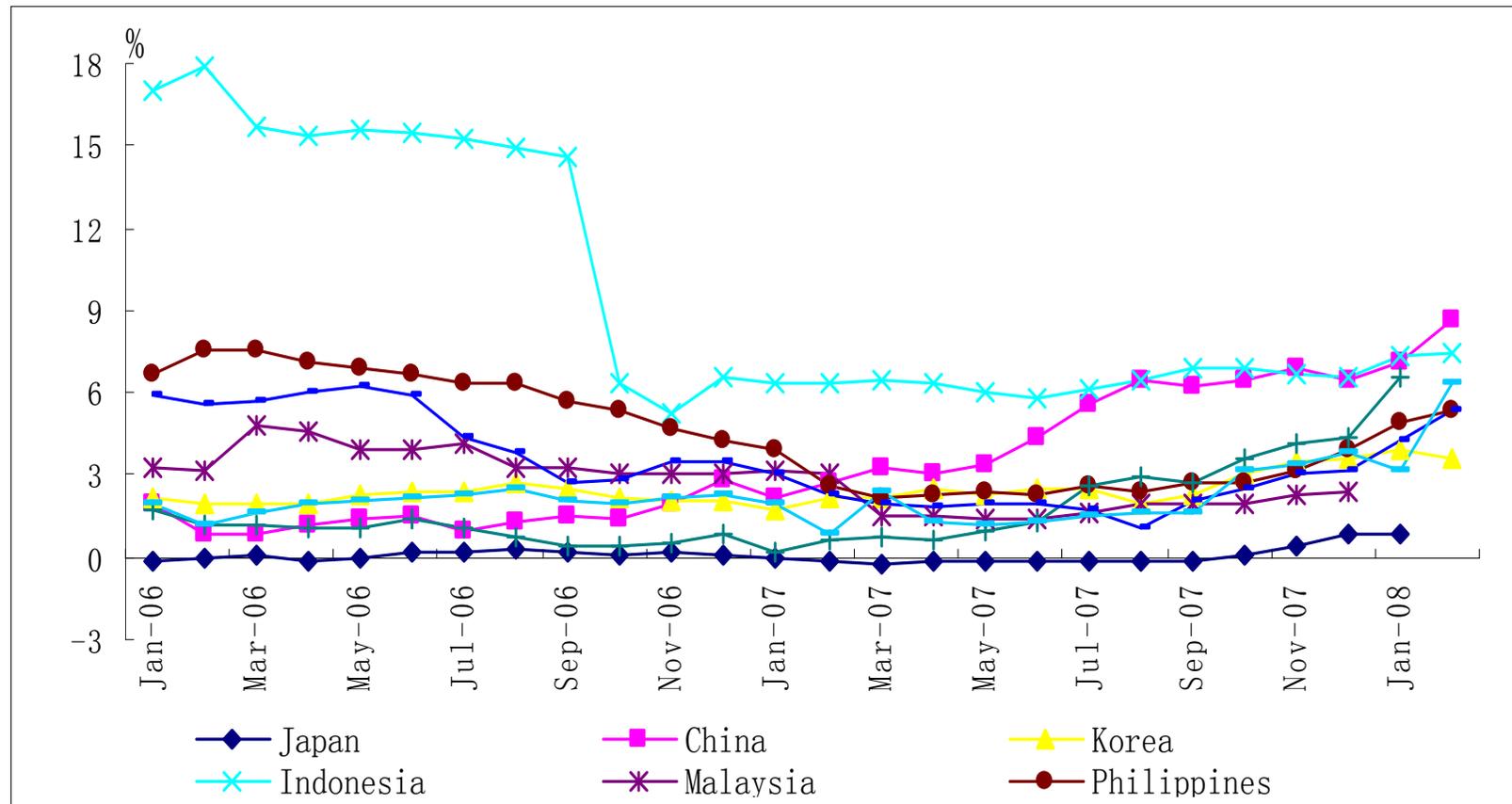
The trend of exchange rate USD against local currencies in East Asia



Foreign reserves in some economy in EA

	Dec-06	Dec-07
Hongkong, China	1333	1527
Indonesia	426	569
Japan	8953	9734
Korea	2391	2624
Malaysia	832	1195
Phillipeens	231	339
Singapore	1363	1630
Thailand	670	878
Mainland China	10663	15282
SUM	26862	33778

The price trend in East Asia economy



Monetary Policy during Subprime Crisis



Rebuild Financial Institutions and Confidence

- Re-regulation of the financial industry
- Active response to the economic slowdown
- Investing in our future

How to uncouple from US

- ❑ To escape from the crisis in the next round, early measures of **financial cooperation** should be take
- ❑ Financial sector cooperation should be **deepened**
- ❑ Monetary cooperation should be **strengthened**

Financial Sector Cooperation

- government sectors such as **central banks**, supervision bodies, and financial institutions should be in the process of cooperation
- **East Asian Financial Association** which be put forward in 2006 may be a suitable choice

How to strengthen monetary cooperation

- ❑ Make CMI BSA more effective in reducing the foreign reserves, East Asian Monetary Fund (EAMF) may be a suitable choice for CMI BSA
- ❑ Establish a regional payment and clearing system like European Payment Union in East Asia as the first step
- ❑ Make formal studies on ACU Or ACI and the roadmap of East Asian Monetary System

Fiscal Policy-"Keynesian" response

- ❑ enhancing the credibility of the government's policies
- ❑ good budget targets are set and maintained
- ❑ increase government spending and deficit
- ❑ reduce unproductive and wasteful public expenditures
- ❑ Stronger regulation and tax reform

Fiscal Policy-Interaction with Monetary Policy

- ❑ finance a needed restructuring of the financial sector
- ❑ print more money
- ❑ strengthening a country's foreign exchange reserves

Fiscal Policy-Public Welfare

- maintain and expand public services
- provide jobs for social members
- unemployment compensation
- targeted food subsidies

Reference

- Wiki Encyclopedia
- FT中文网
- New York Times
- Acknowledgement: DV co-edited by Evan Shen(friend of Lei Qiongwen)



Thanks !