Reference - Mishkin chapter 15

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**A financial crisis** occurs when an increase in asymmetric information ( worsening adverse selection and moral hazard problem) prevents the financial system from channelizing funds efficiently from lenders-savers to borrowers-spenders, the households and firms with productive investment opportunities.

**Dynamics of Financial Crises**

Financial crises in advanced economies have progressed in two or three stages

**Stage One: Initiation of Financial Crisis**

A financial crisis can begin in several ways:

1) **Mismanagement of Financial Innovation/ Liberalization**- **Financial Liberalization** ( elimination of restrictions on financial markets and institutions) and **financial innovation** ( introduction of new types of loans or other financial products) can sow the seeds of financial crisis. Liberalization leads to **credit boom** ( huge increase in lending). While lenders may not manage risk appropriately in new lines of business worsening the asymmetric information problem. Combined with deposit insurance, losses on loans begin to mount. With less capital, financial institutions indulge in **deleveraging** i.e. cut back on their lending. Increased risk results in lenders pulling out their funds leading to credit freeze. Lending boom turns into a lending crash. Decrease in investment leads to contraction of economic activity.

2**) Asset price boom and bust**- Sometimes credit booms leads to "irrational exuberance" on the part of investors driving the prices of assets above their **fundamental economic values** ( values based on realistic expectations of the assets' income streams) leading to asset price bubble. When bubble busts and asset prices fall, net worth of financial institutions fall leading to deleverage and decline in aggregate demand and economic activity.

3) **Increase in Uncertainty**- it leads to less information in the economy worsening asymmetric information problem leading to reduced lending and economic activity.

**Stage 2: Banking Crisis**- Decreasing net worth, deteriorating balance sheet and tough business conditions lead to bank panic i.e., multiple banks failing simultaneously. Uncertainty about the health of the banking system leads to run on banks, both good and bad. It will cause banks to indulge in fire sales i.e. selling off assets quickly to raise funds leading to decrease in asset price.

**Stage 3: Debt Deflation** - The economic slowdown leads to sharp decline in the price level. Since many debt contracts are have fixed nominal interest rates for long maturity, it leads to rise in the real value of borrower's liabilities leading to decrease in its real net worth. This results in decline in lending and economic activity for a long time.

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**Types of asset price bubbles**

2 types

1) **Credit boom driven bubbles**- due to credit boom, demand for assets increase leading to exuberant increase in their prices. There is a feedback loop (see figure 15.10) where a credit boom drives up asset prices which in turn further fuels the credit boom ( due to increased value of capital and collateral and thus increasing lending and borrowing capacity ) and thus asset prices. Bust of bubble leads to reversal of the loop. Lending decreases, demand for assets declines further and prices drop even more.

2) **Optimistic expectations- driven bubbles**. These are less severe compared to credit driven bubbles.

**Policy response to bubbles**

Sometimes the central bank doesn't know about the asset price bubble. However when asset prices are rising rapidly at the same time that credit is booming, then there is likelihood that there is asset price bubble.

A) **Monetary contraction**

It can work sometimes but there are three strong reasons that monetary contraction should not be used to pop credit driven asset price bubbles.

1) high real interest rate may be ineffective when market participants continue to expect high rates of return from buying bubble driven assets. Even if it helps, it can lead to major damage in the economy.

2) Prices of all, and not just bubble driven assets fall.

3) high real interest rates lead to decline in aggregate demand, job losses and huge deflation.

B) **Macroprudential regulation**- it is the regulatory policy that affects credit market in the aggregate. Financial regulation and supervision in an ongoing basis can prevent excessive risk taking and avoid credit driven asset price bubbles.