

The Complete-Idiot's Guide to Dealing with Financial Crises

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Introduction

Why an Idiot's Guide?

We've forgotten things we used to know.

Introduction

- "This Time is Different."

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- "When you've seen one financial crisis
.... you've seen one financial crisis."

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- Is every potato different?

Introduction

- "This Time is Different."
- "When you've seen one financial crisis
.... you've seen one financial crisis."
- Is every potato different?
- To understand accidents,
talk to ambulance attendants.

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- Introduction
- Preventing Financial Crises

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- What to Expect in a Crisis

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- What to Expect in a Crisis
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- Conclusions

Preventing Financial Crises.

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- 1 Crises are like forest fires;
don't sweat the small stuff.

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- 2 Prevent Banking Panics

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- 3 Banking Panics usually caused by large real estate bubbles.

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- 3 Banking Panics usually caused by large real estate bubbles.
- 4 ***DON'T ALLOW LARGE REAL ESTATE BUBBLES!***

Preventing Financial Crises.

BIS (2004) *Bank Failures in Mature Economies*

Looked at major bank failures in the G10, 1980-2000

- *The widespread banking crises that involved credit risk were remarkably similar.*

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 - *Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases.*

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 - *A period of financial deregulation resulted in rapid growth in lending, particularly in real estate related lending.*
 - *Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases.*
 - *When economic recessions occurred, inflated real estate prices collapsed, leading directly to the failures.*

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 - *Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases.*
 - *When economic recessions occurred, inflated real estate prices collapsed, leading directly to the failures.*
- *All the episodes that involved large amounts of public support [i.e. taxpayer funds] were caused by credit risk problems.*

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Why has Canada had such a mild crisis?

- Milder housing bubble than US
(and Ireland, UK, Spain, ...)

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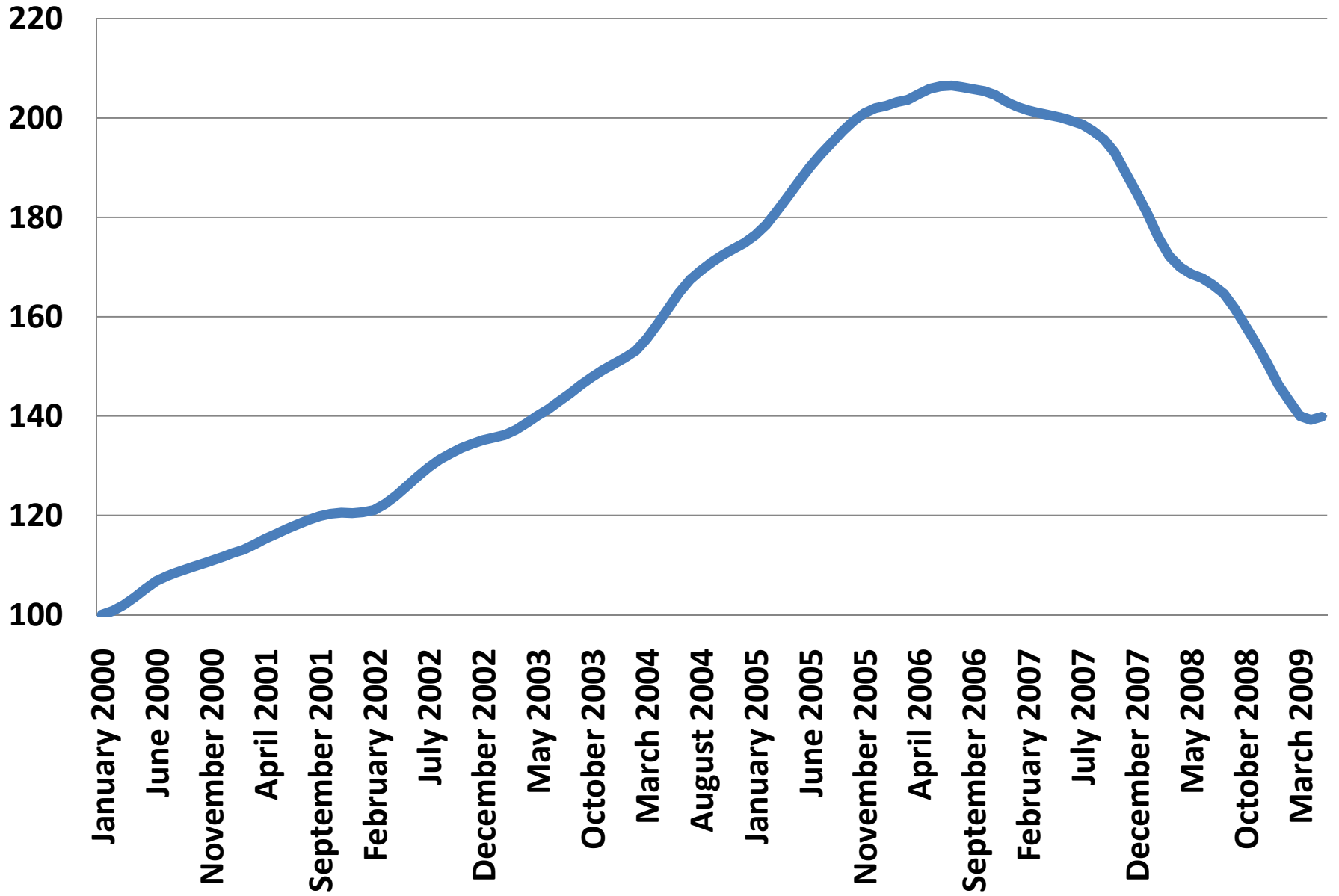
Conclusion

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Why has Canada had such a mild crisis?

- Milder housing bubble than US
(and Ireland, UK, Spain, ...)
 - Lower household debt
 - Mortgages: LTV lower, insurance, less non-prime
- Bank have bigger reserves, regional diversification
 - Doubtful they would survive a nationwide $>30\%$ drop in real estate values.

Case-Shiller 20-City US House Price Index



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Think about the reforms currently under discussion

- Ban naked short selling.
- Reform executive compensation.
- Centralized clearing of CDS & other OTC derivatives.
- Consolidating financial regulators.
- Reform of rating agencies.
- *[Your favourite proposal goes here]*

What effect will all of this have on real estate bubbles?

Preventing Financial Crises.

Why not also consider proposals to reduce household leverage?

- Require govt. insurance of high LTV mortgages.

Preventing Financial Crises.

Why not also consider proposals to reduce household leverage?

- Require govt. insurance of high LTV mortgages.
- Cap mortgage-interest deductability (\$100,000?)

The Aftermath of Banking Crises

What happens after a typical developed-country banking crises?

Reinhart and Rogoff (2008)

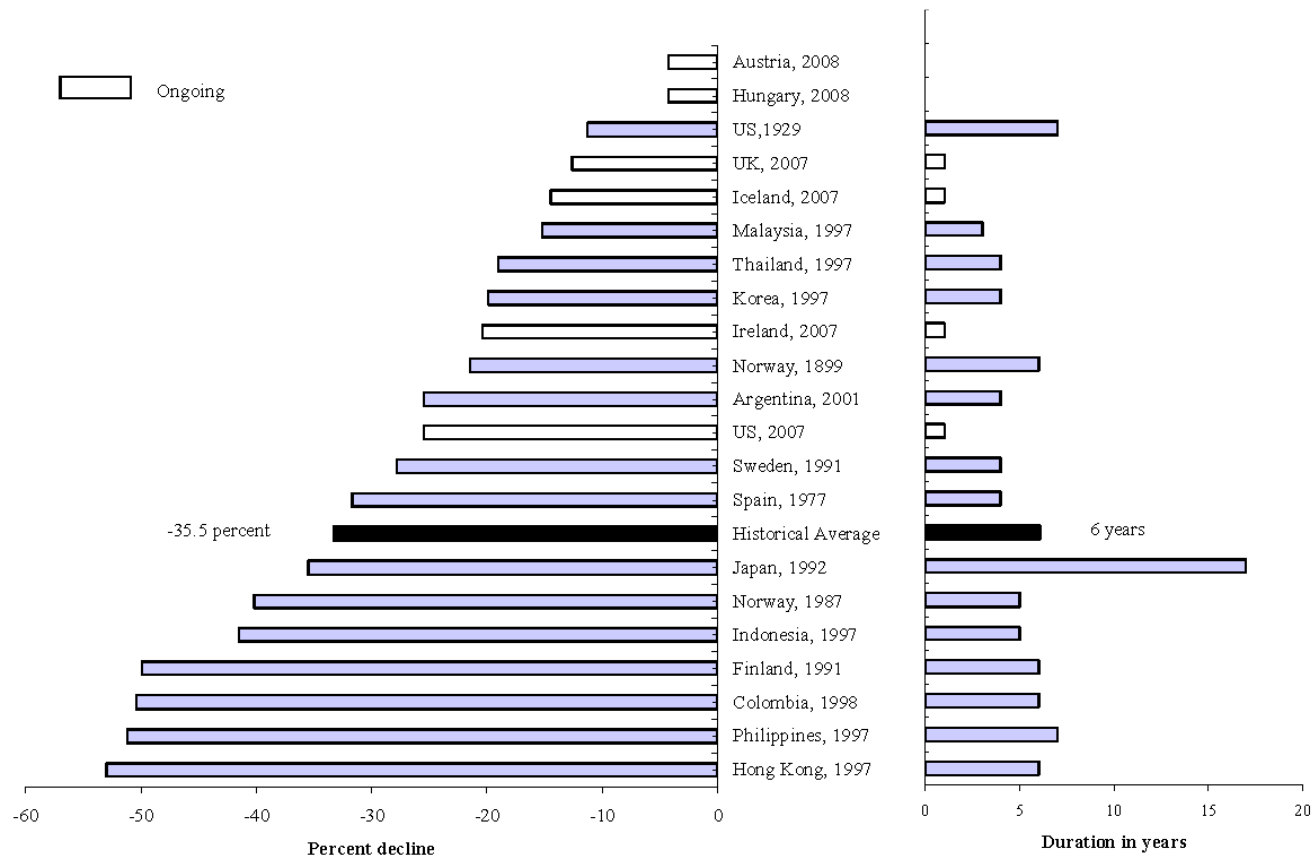
- Look at 7 countries with banking crises since 1980 + 2 old housing crises.

Reinhart and Rogoff (2008b)

Figure 1

Past and Ongoing Real House Price Cycles and Banking Crises:

Peak-to-trough Price Declines (left panel) and Years Duration of Downturn (right panel)

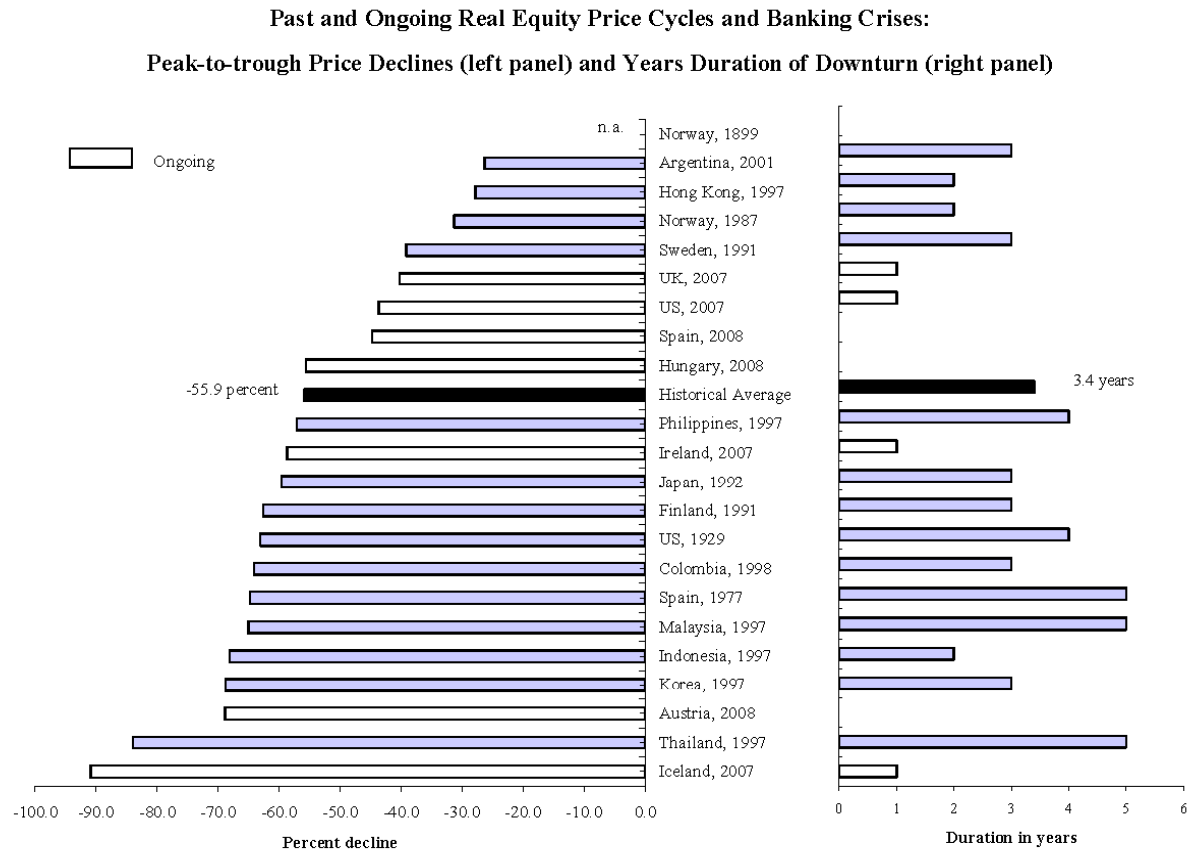


Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Consumer price indices are used to deflate nominal house prices.

Reinhart and Rogoff (2008b)

Figure 2



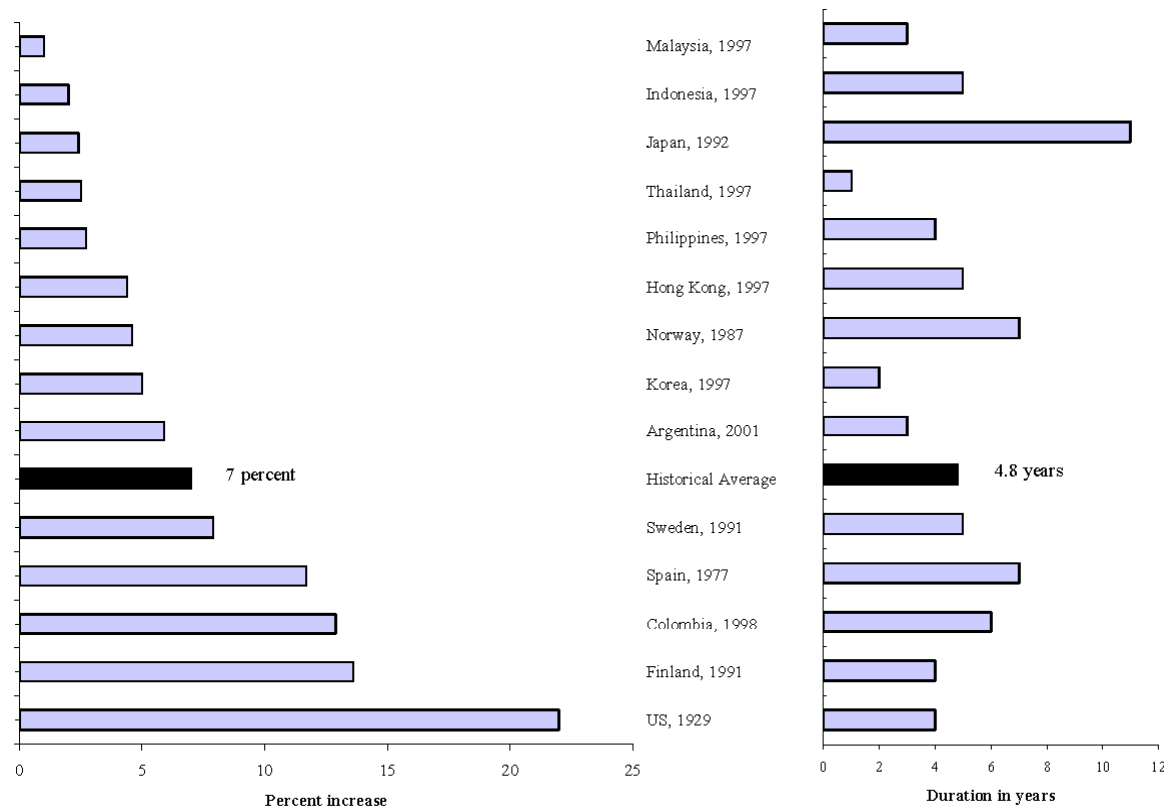
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Figure 3

Past Unemployment Cycles and Banking Crises: Trough-to-peak
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



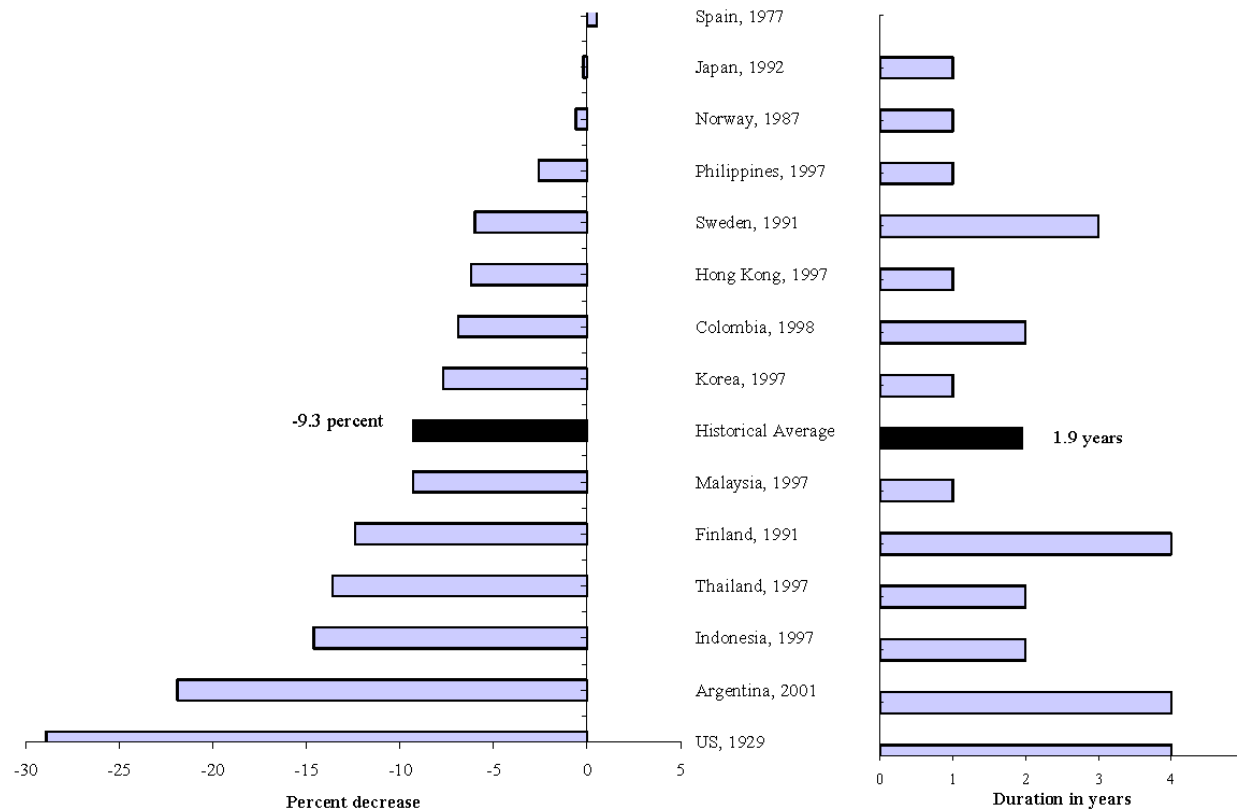
Sources: OECD, IMF, Historical Statistics of the United States (HSOUS), various country sources, and authors' calculations.

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Figure 4

Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



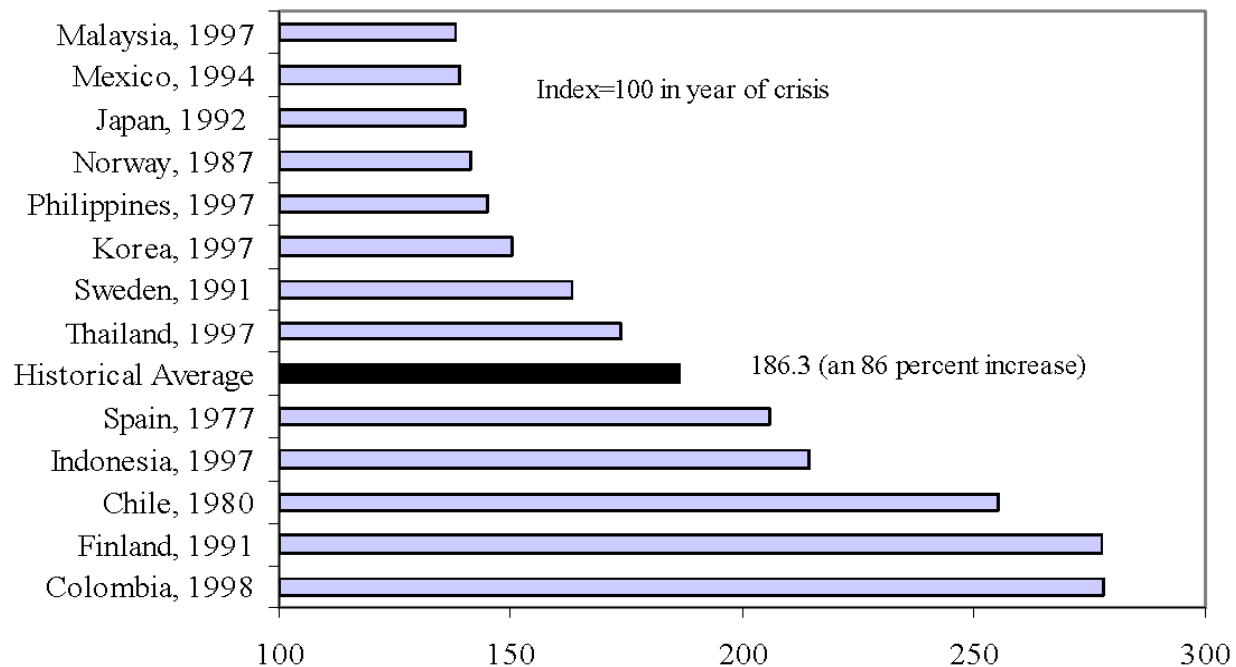
Sources: Total Economy Database (TED), Historical Statistics of the United States (HSOUS), and authors' calculations.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Total GDP, in millions of 1990 US\$ (converted at Geary Khamis PPPs) divided by midyear population.

Reinhart and Rogoff (2008b)

Figure 5

Cumulative increase in real public debt in the three years following the banking crisis



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

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What happens after a typical developed-country banking crises?

- Average house price fall 35% over 6 years

But this crisis is more global than usual.

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What happens after a typical developed-country banking crises?

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- **Output falls 9% over 2 years**

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- Output falls 9% over 2 years
- Real government debt almost doubles (+86%)

But this crisis is more global than usual.

How to Minimize the Cost of a Crisis

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How Expensive is a Banking Crisis?

- We've seen some typical economic costs.

Costs vary widely depending on how governments respond.

How to Minimize the Cost of a Crisis

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- How govt. responses changed govt. costs.

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- Honohan and Klingebiel (2003) - World Bank project
- How govt. responses changed govt. costs.
- **Examine over 40 crises.**

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Honohan and Klingebiel (2003) find

- Direct costs to govt. average 12.8% of GDP.

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- Govt. response explains much of the variation in costs.

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- Huge variation across countries
 - Worst case costs around 50% GDP
- Govt. response explains much of the variation in costs.
 - "Everything wrong" costs 60%
 - "Everything right" costs 1%

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- 1 Avoid blanket deposit guarantees. (Ireland.)

Tough Love looks cost effective.

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- 4 Avoid open-ended liquidity support.

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- 4 Avoid open-ended liquidity support.
- 5 Avoid repeated partial capitalizations. (AIG)

Tough Love looks cost effective.

Conclusion

Karl Marx:

*History repeats itself; first as tragedy,
then as farce.*

Rahm Emanuel:

*You never want a serious crisis to go to
waste.*