Things Fall Apart

Source: Crisis Economics Roubini and Smith, cap. 4.

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Introduction

Walter Bagehot wrote about financial crisis in 1873: **low transparency** helps making **profits** in good time but it creates a **'terra incognita'** during a crisis.

Low transparency means that during a panic agents are not able to distinguish **illiquid** company from insolvent ones.

Citigroup in 2007 had problems because of its investments in financial assets were not transparent, suddenly the intra-bank lending market freezed.

In case of panic Bagehot recommended to have a lender of last resort that provides liquidity in exchange of **high interest rate** and **good collateral**.

The Minsky moment

By the spring of 2006 the financial system was on the verge of collapsing. The **level of leverage** was very high and the **belief in growing asset** prices was crucial for its stability.

In he spring of 2006 the **price of houses** stopped its growth, essentially the **supply** was quite larger than the demand and the **interest rate** increased.

Increased the rate of **default on mortgages**, because of higher rate and not anymore increasing house prices.

The Minsky moment

Several shadow banks specialized in mortgages failed, because they borrow short from banks and banks have fear to offered them credit. A **twenty first century bank run**.

Bernanke in 2007 affirmed that the crisis was limited to the subprime sector.

ABX index was created to value asset back seurity and it showed that their real value was very low

But suddenly all the financial agents start to fear about the real value of asset back security, trying to maintain liquidity and reducing leverage, the **panic shock started** and the pyramid of credit collapsed.

Hedge Fund Failure

By summer three edge funds associated with UBS and Bear Stream failed. **Hedge funds** borrow short from investment bank to buy long term titles as ABS, when the value of ABS decline even their value collapses.

A **slow motion bank run** happened, after the first three edge funds 500 other failed.

Also **SIV and conduits** there are institutions created by banks to generate and sell ABS, they are created to avoid regulation on leverage. In many cases banks had to cover losses.

By August 2007 credit crunch not only the shadow banking but also **regular banks** came under attack.

Risk and Uncertainty

Risk can be computed while uncertainty not. When the market began to be **uncertain** the crisis explodes.

When two edge funds of Goldman Sachs **lost one third of their value**, they said it was a twenty five standard deviation event, but the computation was based on the idea that price of house always increase.

The main sign of the crisis was the **credit crunch**, the incredible rise of the LIBOR from 10 basis point to 70. Banks did not want to lend each other any more.

Credit crunch has also impact on the **real economy**, the credit system doesn't work any more, so central bank intervention of last resort.

Illiquid and Insolvent

Public intervention should focus on try to save illiquid banks and not insolvent ones, the problem is how to set the line between illiquid and insolvent (Mervin King, governor of the Bank of England) .

As the **value of assets** deteriorates also the illiquid bank may become insolvent.

Moreover, we assisted to **bank runs**, it happened to Countrywide bank and Northen rock, their assurance on deposits was 100.00 dollars and 30.000 respectively

Bank of England governor **extended the insurance** to all the deposits of all the banks.

The Eye of the storm

In the winter 2007-2008 many analysts thought that the crisis was over, but financial crisis are based on fundamental problems so they advance as **hurricane** increasing and decreasing their strength until the fundamental is not resolved.

Many **banks circled their wagons** (lending less, with more attention).

Asian funds provided liquidity to US and European banks and the **central banks** offered long term credit to banks.

But the real economy entered in recession.

The Center cannot Hold

Investment banks of US entered a deep crisis. An investment bank borrow short to invest long as ordinary bank, but it has not deposits, thus not deposit insurance. Moreover not any lend of last resort certainty and higher level of leverage (Lehman Brothers, Merrill Lynch, Morgan Stanley, Goldman Sachs etc..)

Bear Stearns was bailed out by the government.

Fanny Mae and Freddie Mac that were under the control of the government were bailed out, they issued mortgages but also bought MBS.

More anarchy is loosened upon the world

In **1907 J.P. Morgan** organized the rescue of the Trust Company of American saving the financial system

In September 2008 Treasury Secretary Henry Paulson tried to do the same with **Lehman Bothers** but he failed. on 15th of September Lehman Brothers Failed. Was moral reestablished?

The crisis grew in intensity, the assurance company **AIG**, that assured CDO bought by banks was bailed out by the government

The crisis hit also **commercial paper market**, the credit demanded by firms to operate and the FED has to provide credit also to non financial corporations.

More anarchy is loosened upon the world

Also the sector of **bank bonds** was hit by the crises and FED had to intervene to guarantee them.

At the end the **government and central bank intervention was massive**.