Last Resort

Source: Crisis Economics Roubini and Mihn, cap. 6.

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Introduction

When the crisis began, **Ben Bernanke** was had of the FED since one year.

Bernanke was an expert of the '29 Crisis, in particular of **Friedman-Schwartz monetaristic** analysis of the crisis.

The aim is preventing the crisis to **spiral out of control**, using orthodox and heterodox policies.

The risk is **moral hazard** and the risk of larger bubbles and more destructive crises in the future.

Deflation and Its Discontent

Usually the **FED decrease the discount rate** during recession and **increase it** during booms.

Significant crises in 1973, 1979, 1990 and 2000. Supply side shocks that augmented prices followed by restrictive monetary policies, which lead to one or two year recession with **low but positive inflation**.

In the 2008 for the first time since the Great Depression, **inflation was negative**.

Debt Deflation Theory of the Great Depression

Depression due to **too much large debt before** the crisis and **too much deflation at its wake**.

Too much debt means that at the wake of the crisis:

- Agents **sell assets** to reduce their exposure and this reduce its value.
- Agents augments their **monetary reserves** reducing money supply.

The great paradox: **the more people pay the more their debt weigh them down**.

Great Depression

During the **Great Depression**:

- Stock market lost 90% of its value;
- The economy contracted by 30%;
- Unemployment surged to 25%;
- A doze eggs cost 0.53$ in 1229 cost 0.29$ in 1933.

When the deflation gains momentum **conventional monetary policy** tends not to work.

The Liquidity Trap

During the crisis CB put the **interest rate to zero** but credit did not percolate in the system: banks preferred to hold reserves or to buy sure assets.

For instance the **TED**: spread between US short therm debt and the LIBOR: from 30 basis points to 465: no credit among banks and buying safe assets.

High **LIBOR impact directly** on other interest rate as morgages.

Credit Lines

The FED and other CB created **new line of credit**:

- Give credit non only on primary dealers;
- Increase the length of credit.

Moreover they **swapped illiquid assets** for liquid ones.

After Lehman Brother Failure CBs flooded the market with billions of dollars of liquidity and the interest between short term credit and US debt declined.

Last Lender Standing

When liabilities are denominated in a **foreign currency** the CB can help only if it has reserves, you need the foreign currency. Indeed, in case of sudden stop: currency crises.

The **IMF** offered conditional (SBA) and unconditional (FCL) to countries with foreign credit problem: $50 billion and $78 billion. (10 billion to SK in 1997 while 16 billion to Ukraine in 2008).

With the crisis loan in dollar stopped, so the demand for **dollar increased and its value increased**.

FED provided **swap lines** with other currencies ($30 billions to Mexico), in total in 200 half a trillion.

Nuclear Options

Short term loan allow banks to survive, but they use this funds to by very safe assets, in order to increase **credit in the long run**, you must decrease long run interest rate.

Moreover, FED started to buy also other assets as mortgage back securities, to sustain Fannie Mae and Freddie Mac and, thus, allow them to issue new mortgages.

Fed started to swap long term safe assets with illiquid one.

The balance sheet of CBs inflated, the FED: from $900 billion in 2007 to 2,3 trillion in 2009.

Nuclear Options

FED sent a message to market it would do **whatever is necessary** to stop the crisis.

but this at the same time creates enormous **moral hazard problems**: Capitalism without bankruptcy is like Christianity without hell.