Reflections on the Global Financial Crisis

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11 December, 2009

Setting

- Crisis broke in summer of 2007 and intensified in fall of 2008, resulting in deep synchronous global recession
- In recent months, financial conditions improving and global economy recovering, largely as a result of bold policy actions taken
- Aim: overview of situation and lessons
Road map

- Origins of crisis
- Crisis dynamics
- Policy response
- Recovery
- Where are we now?
  - Exit strategy and handoff
- Analytical issues for future
- Policy issues for future
  - Global financial reform
  - Global imbalances
  - Monetary policy

Origins – macroeconomic

- Like emerging market crises, a combination of macro and financial/structural factors—but relative importance disputed
- US current account imbalances, capital inflows
  - Credit boom in US, savings glut in Asia
  - Low interest rates, search for yield
  - Great Moderation
Origins – financial

- Securitization and originate-to-distribute model
- Pervasive weaknesses in risk management
- Fragmentation of focus of regulation and supervision
- Moral hazard

Dynamics of crisis

- Diffusion of crisis initially gradual, followed by sudden unravelling
- Emerging markets initially almost unscathed
- Complex channels of transmission
- Many phenomena akin to bank runs – but also solvency problems
- Asymmetric information – e.g. Queen of Spades problem
Dynamics of crisis – macroeconomic

- Severe, synchronous global recession
- Impact underestimated by most analysts
- International transmission channels: not primarily financial, but also trade, commodity prices, confidence
- Canada underwent severe contraction despite relatively sound financial system

Similarities, differences from 1995-2003 emerging market crises

- Many of the same feedback loops within financial sector and between financial sector and real economy
- But key differences:
  - Crisis originated in US, which could borrow in own currency and thus avoided adverse depreciation dynamics currency mismatches
  - Indeed, US dollar appreciated with repatriation flows - and that helped cushion rest of world
  - Room for countercyclical fiscal policy
  - Exchange rate defended by surplus countries

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Policy response

- Financial
  - Blanket guarantee
  - Bailouts, asset purchases
  - Liquidity support
- Monetary
  - Policy rates to the floor
  - Unconventional policies
- Fiscal
  - Global stimulus exceeded 2 pct of GDP

Where are we now?

- Global financial conditions improving
- Global economic recovery also started
  - Recovery largely driven by emerging Asia
  - US recovery more protracted than usual – more painful adjustment ahead
  - Recovery still heavily dependent on official action – need for handoff to private sector
Exit strategy – two main issues

• Timing
  – Familiar problem—more challenging than usual this time?
  – Risks of early versus late exit
    • Lower bound
    • Fiscal stimulus more effective if time-limited?
• Modalities of removing monetary stimulus
  – Mopping up liquidity – not a major problem
  – Unwinding credit easing – effects on markets
• Fiscal exit much more challenging

Analytical lessons – real-financial linkages

• Three main elements
  – Real impact of financial shocks
  – Implications of financial sector in transmitting macro shocks and policies
  – Extracting macro information from financial data
• None of these issues new – but all three received greater impetus from crisis
Real-financial linkages – approaches

• Building richer financial sector into DSGE models (e.g. GEM, ToTEM)
• Models with information asymmetries
  – Meh and Moran 2009
  – Dib 2009
• Empirical work on implications of financial conditions

Global financial reforms

• Need to address fundamental weaknesses in supervision and regulation
  – Concern that otherwise, moral hazard exacerbated by crisis – lesson that it pays to be too big and complex to fail
• Need for global action because of
  – Spillovers
  – Regulatory arbitrage
• Program of G-20 and FSB
Key reform proposals

• Macro-prudential approach
  – Capital over the cycle
• Coverage of supervision
• Living wills
• Continuous markets
  – Central counterparties
  – Liquidity provision

Global imbalances

• Narrowed with recession
  – US households scared into thrift
  – Massive Chinese stimulus
• How sustainable is the improvement?
• Need for exchange rate adjustment
Monetary policy

- Crisis occurred despite low and stable inflation
- Financial shocks risked triggering deflationary spiral – benefits of anchoring expectations
- Zero lower bound – is it as scary as we thought?
- Monetary policy before the crisis – a contributing factor (e.g. “Greenspan put”)?
- “Lean or clean”

Monetary policy and financial stability

- Should monetary policy respond to financial information? Of course!
- Should monetary policy act against financial fluctuations even at cost of deviating from inflation target? Less clear
  - Time horizon
  - Assignment problem – regulation preferred tool
  - Need to understand interactions between monetary and financial policies
Conclusions

• Innovative approaches during crisis – need to assess results
• Urgency of making progress – to avoid bigger and messier crises
• Pressing need for fresh insights and analysis