

Economics 435
The Financial System
(1/22/13)

Instructor: Prof. Menzie Chinn
UW Madison
Spring 2014

Administrative Issues

- Course website:
http://www.ssc.wisc.edu/~mchinn/web435_s14.html
- OH: MW 2-3, 7418 Soc Sci
- Textbook: Chinn/Frieden, *Lost Decades*
- Cecchetti/Schoenholtz, or Mishkin
- Additional Readings: from web, Econbrowser, CBO
- *NYT, FT, WSJ, Economist*

Administrative Issues

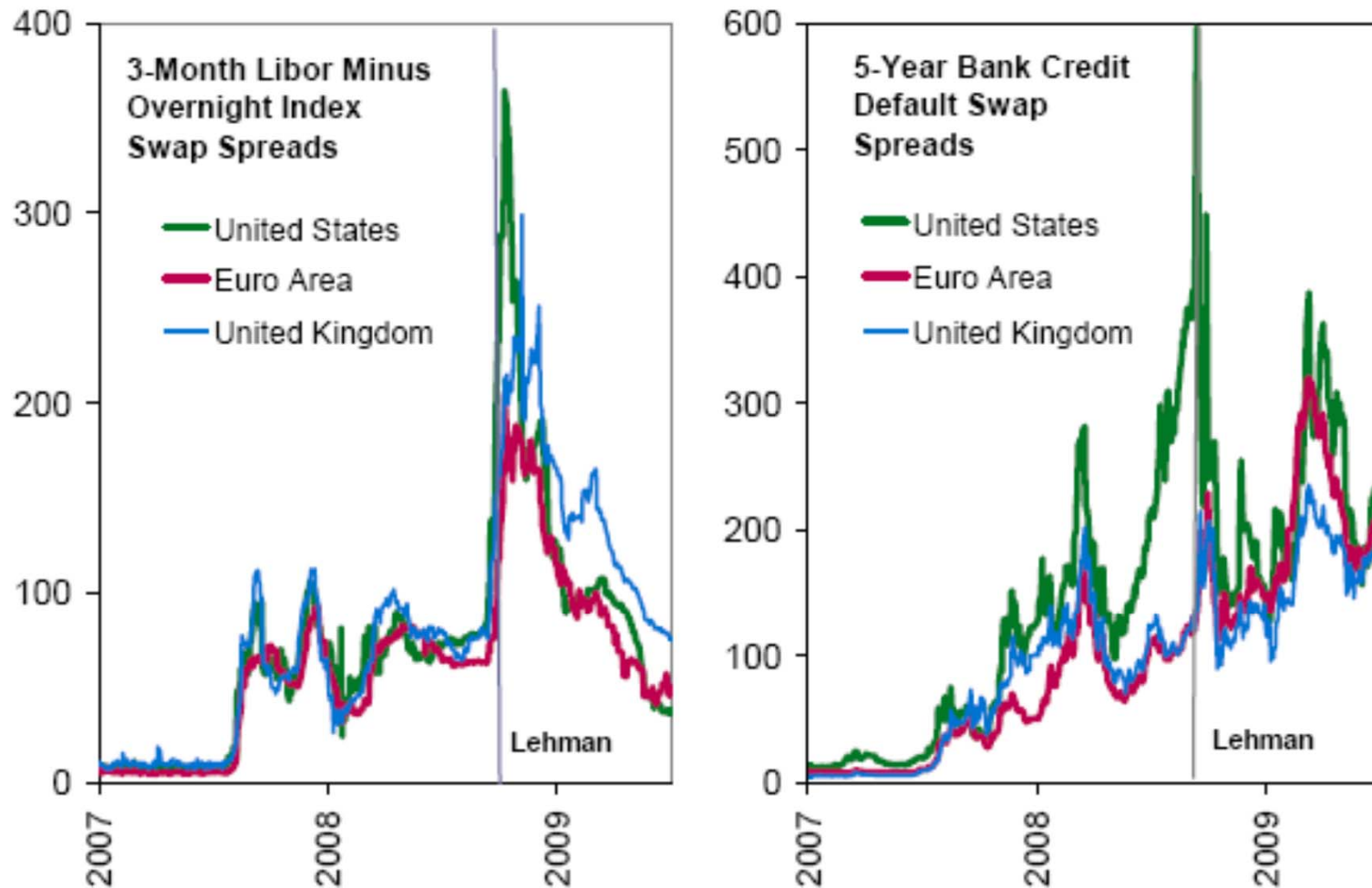
- Grading: 10% PS, 45% 1×MT, 45% paper
- Dates:
 - MT on 4/16
 - **Paper due on Fri, 5/9**
- Make-ups: **None**. Points are re-allocated *if* you have a legitimate excuse. **No** late assignments accepted (must be handed in during lecture)

Outline

- The Financial Crisis of 2008-09
- The Great Recession of 2007-09 and the slow recovery
- Extraordinary monetary policies
- Europe
- IS-LM

Risk and Crisis

Figure 1. Bank Systemic Risk Indicators
(In basis points)

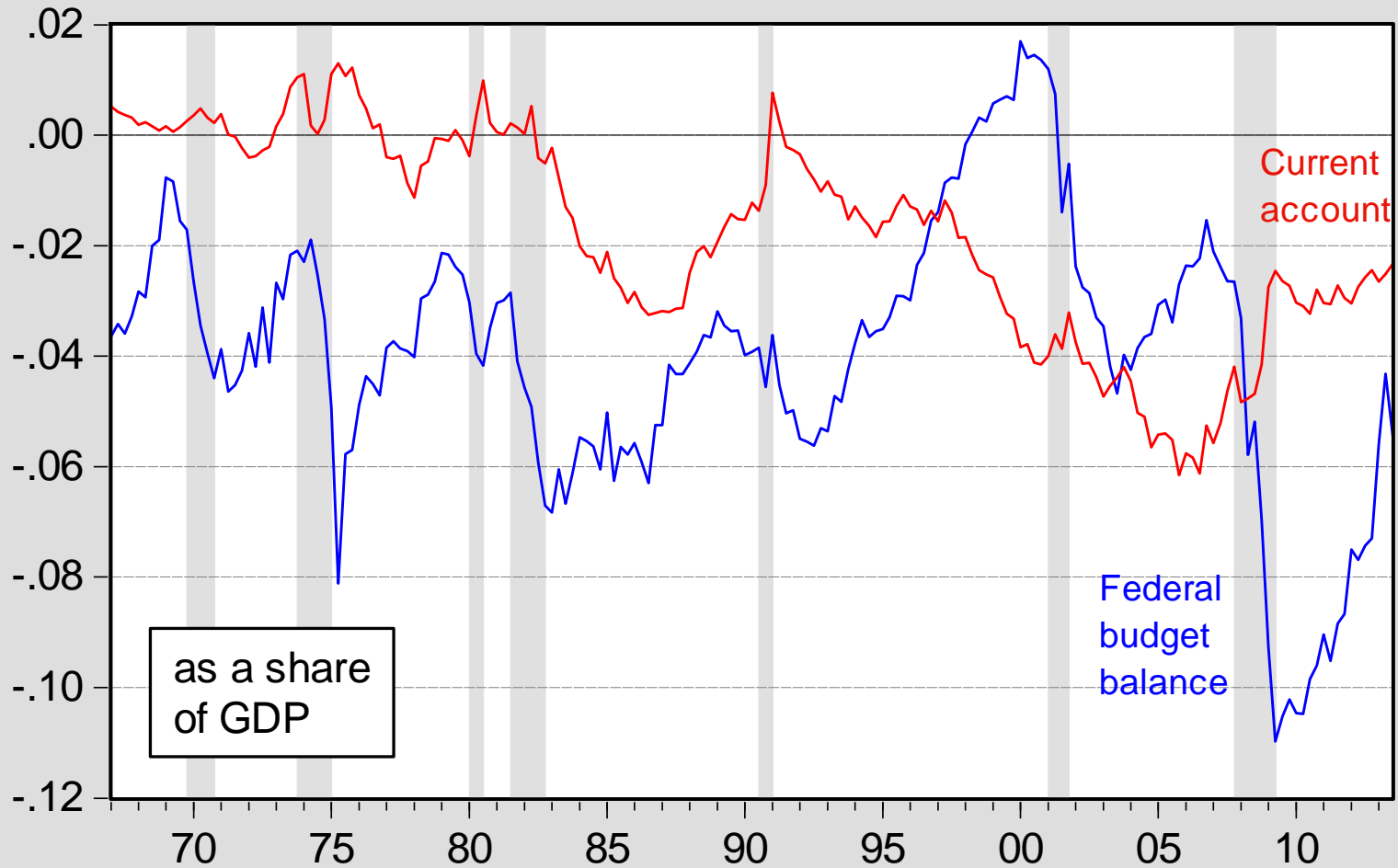


Sources: Bloomberg L.P.; and Datastream.

Motivating Questions

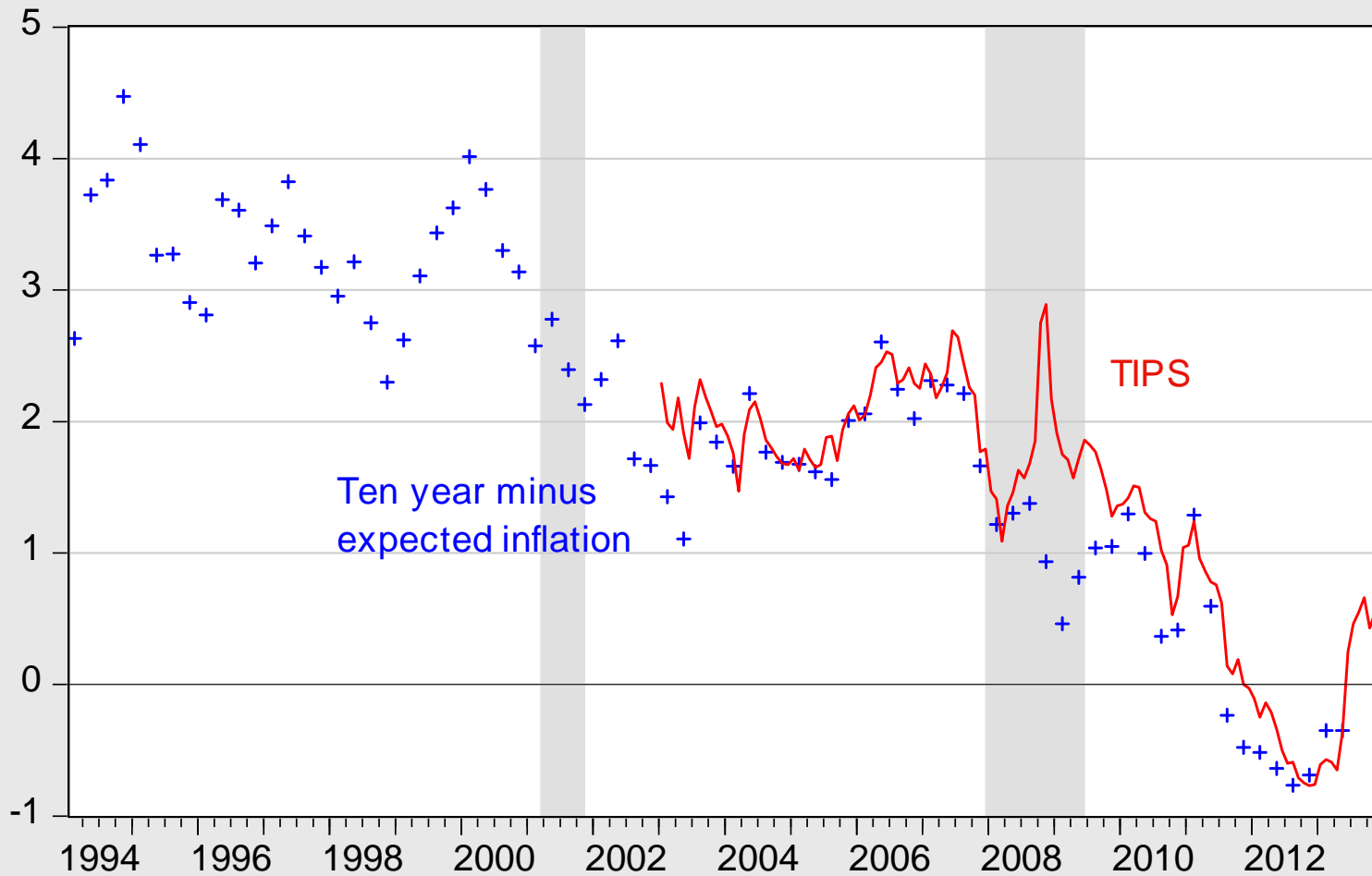
- Why did the financial crisis occur?
- Was it all financial?
- How did financial problems get transmitted to the real side?
- What are the similarities and differences between the past episodes (e.g., the 1929 crash) and this crisis.

Government and national borrowing



Note: Fed. Budget balance is net lending. Source: BEA

Real interest rates

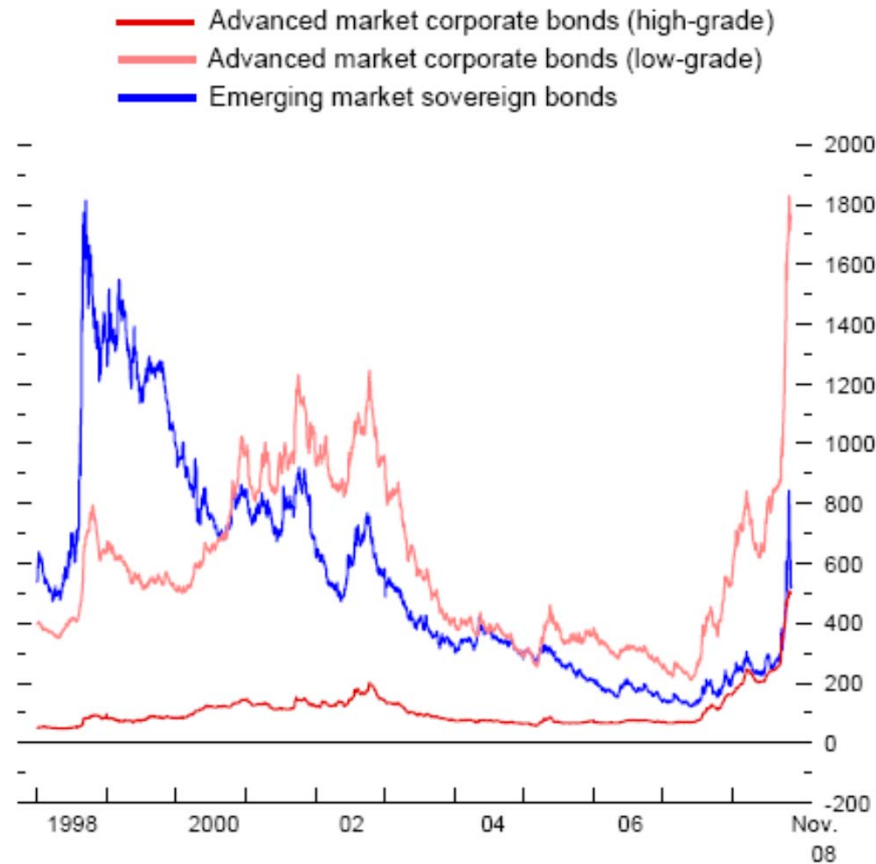


Source: Federal Reserve Board, Philadelphia Fed *SPF*

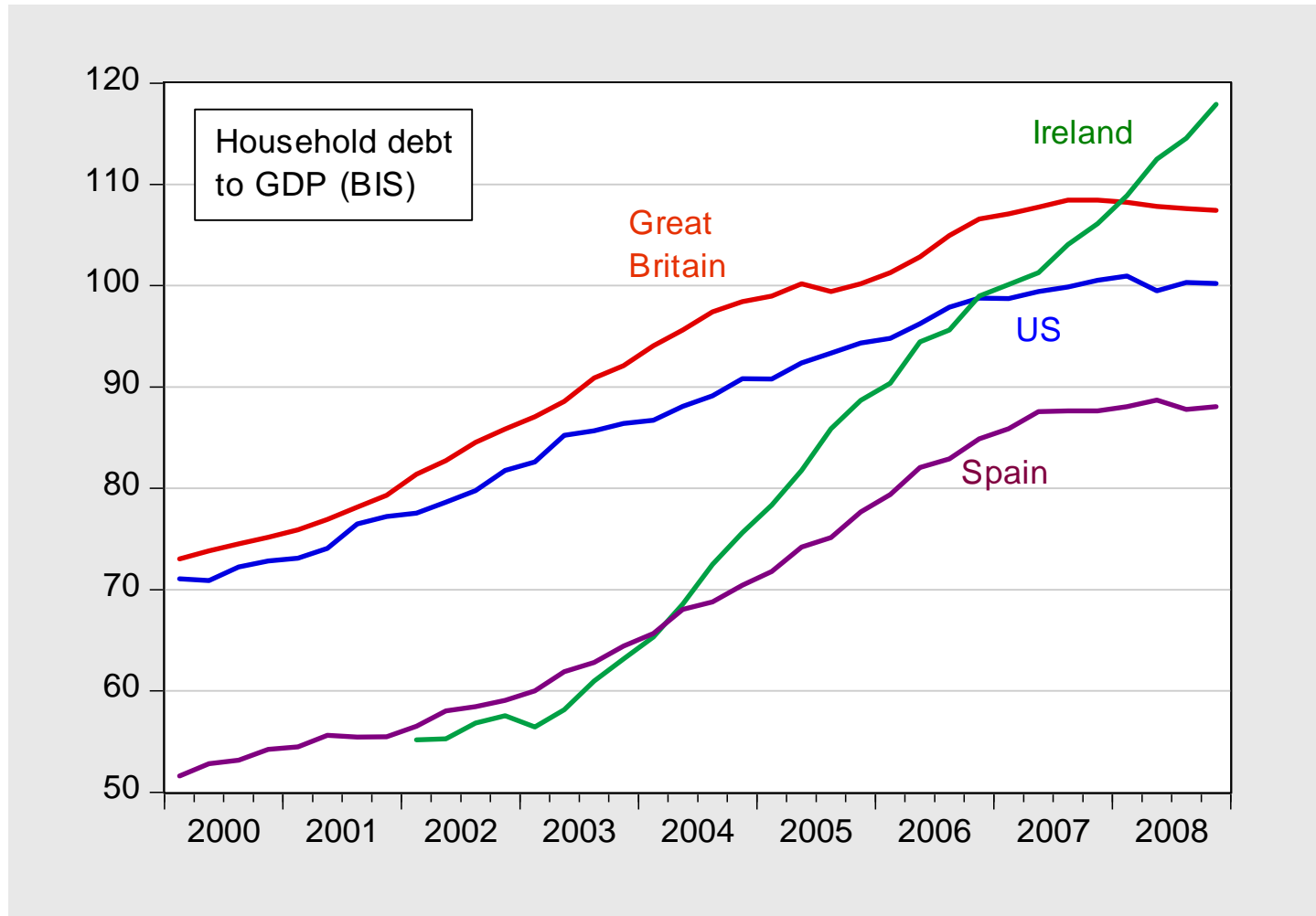
The “Disappearance” of Risk

Figure 3. Advanced and Emerging Markets: Sovereign and Corporate Bond Spreads, 1998–2008 ¹
(In basis points)

Source: IMF, *WEO* update,
11/6/08

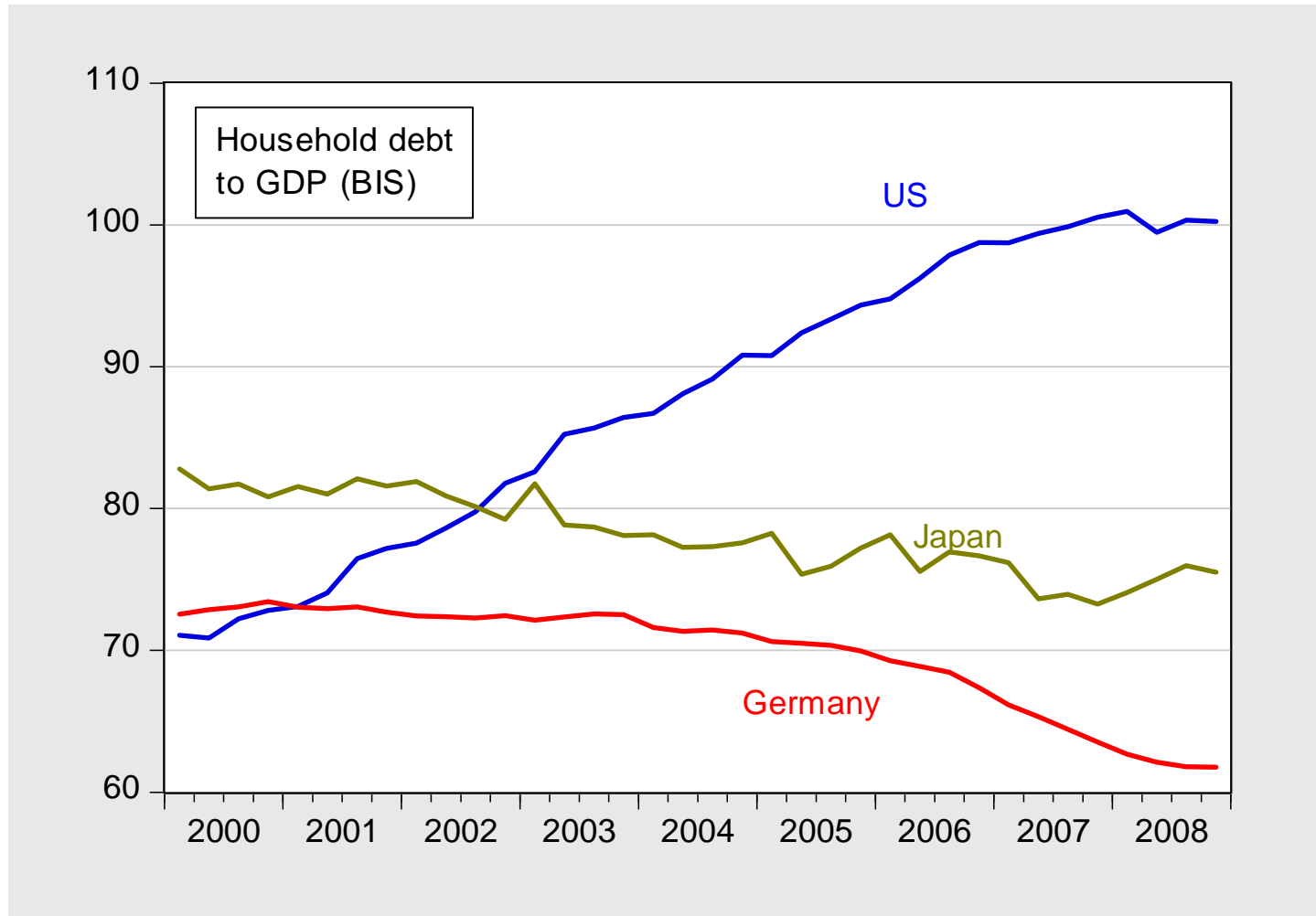


Household debt (I)



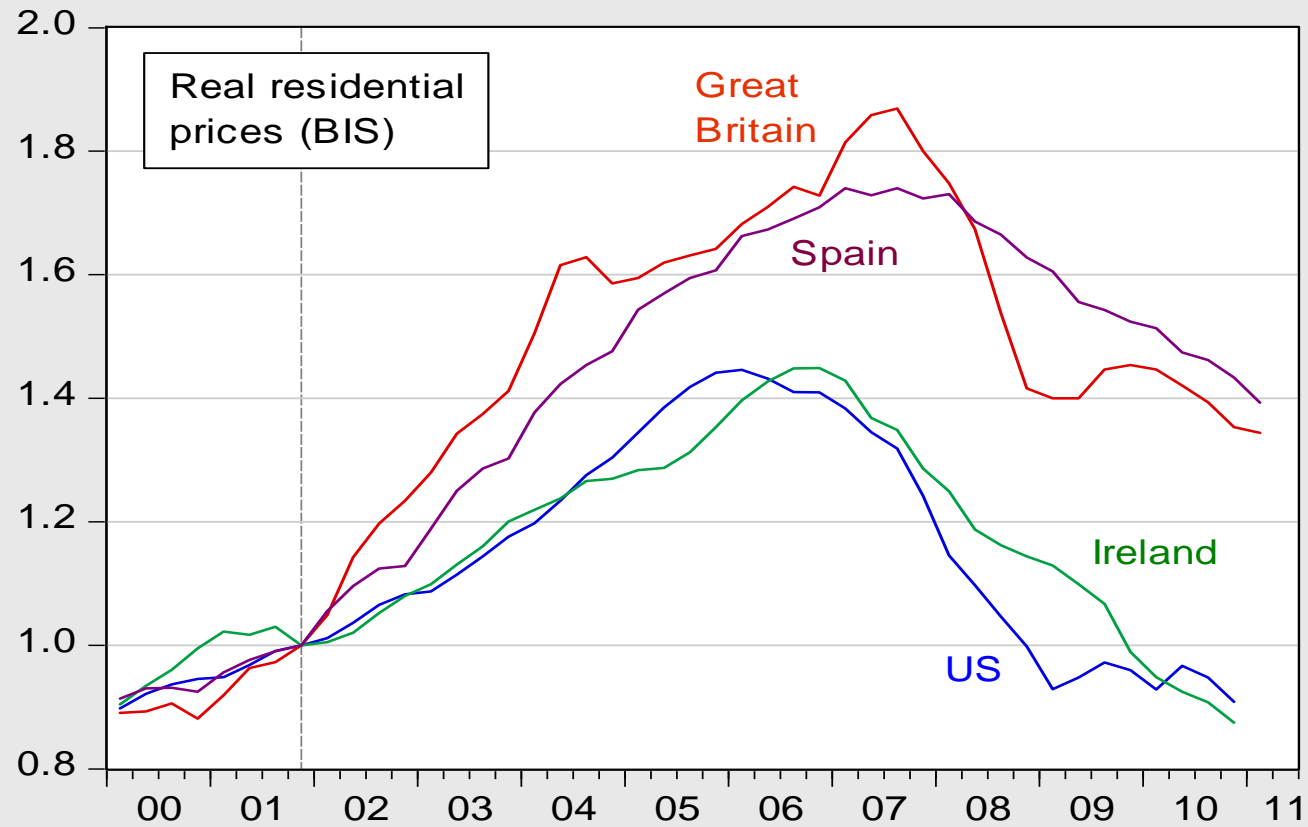
Source: BIS, *Annual Report* (2011)

Household debt (II)



Source: BIS, *Annual Report* (2011)

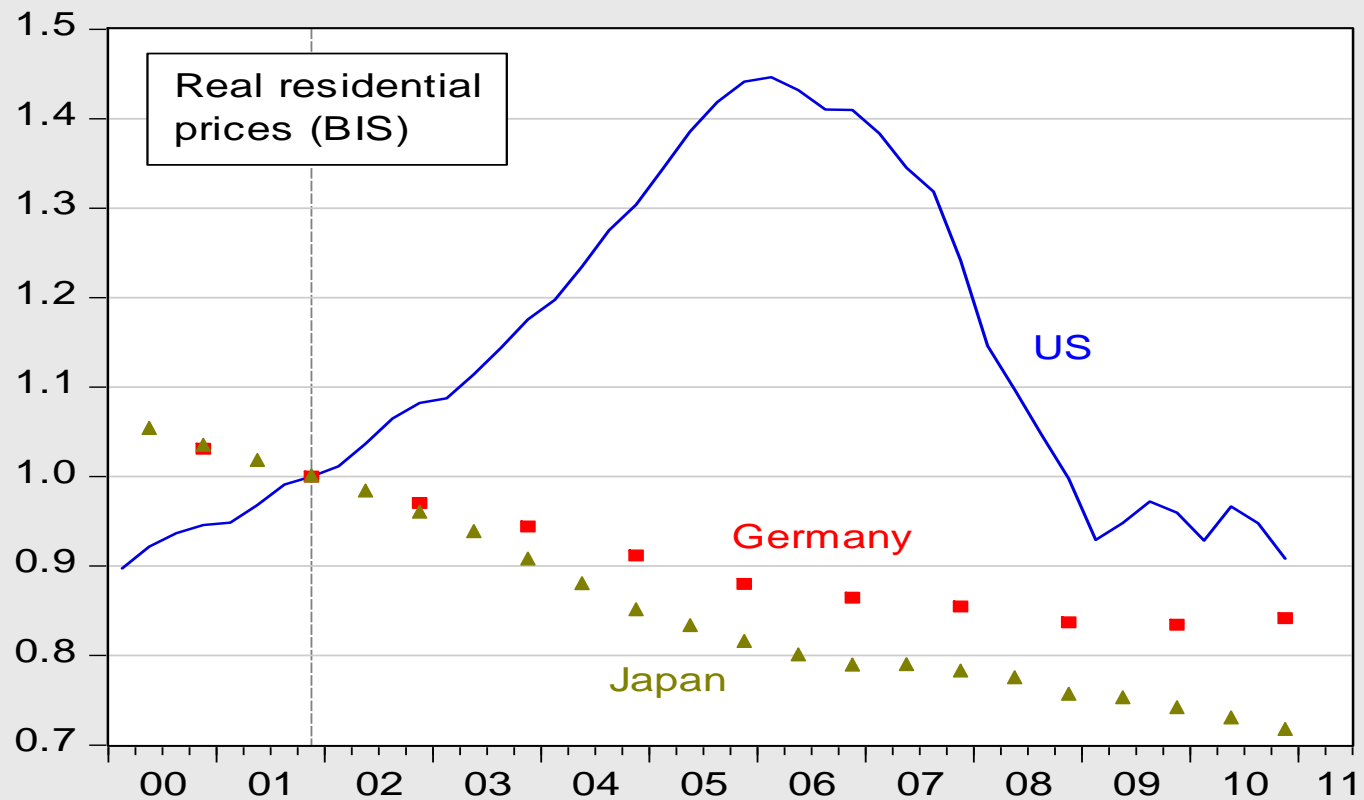
Housing boom (I)



Note: Rescaled to 2001Q4=1.

Source: BIS, Annual Report (2011)

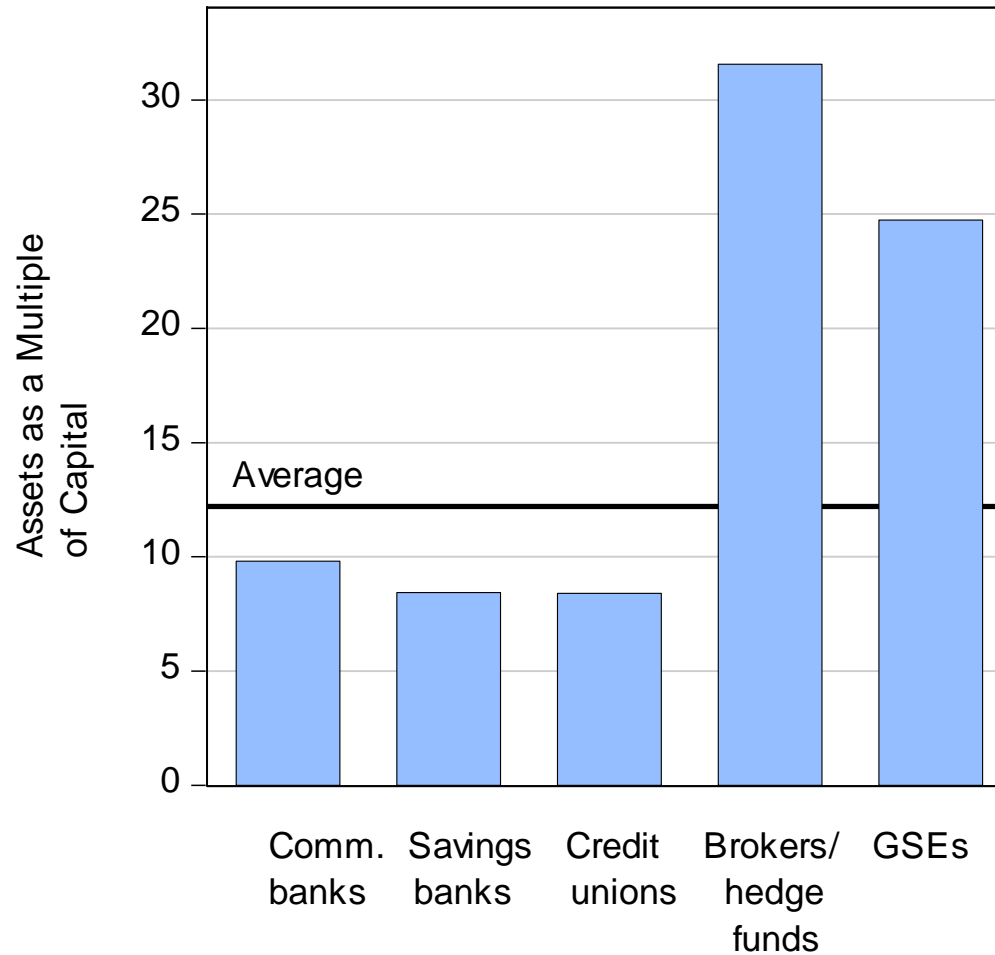
Housing boom (II)



Note: Rescaled to 2001Q4=1.

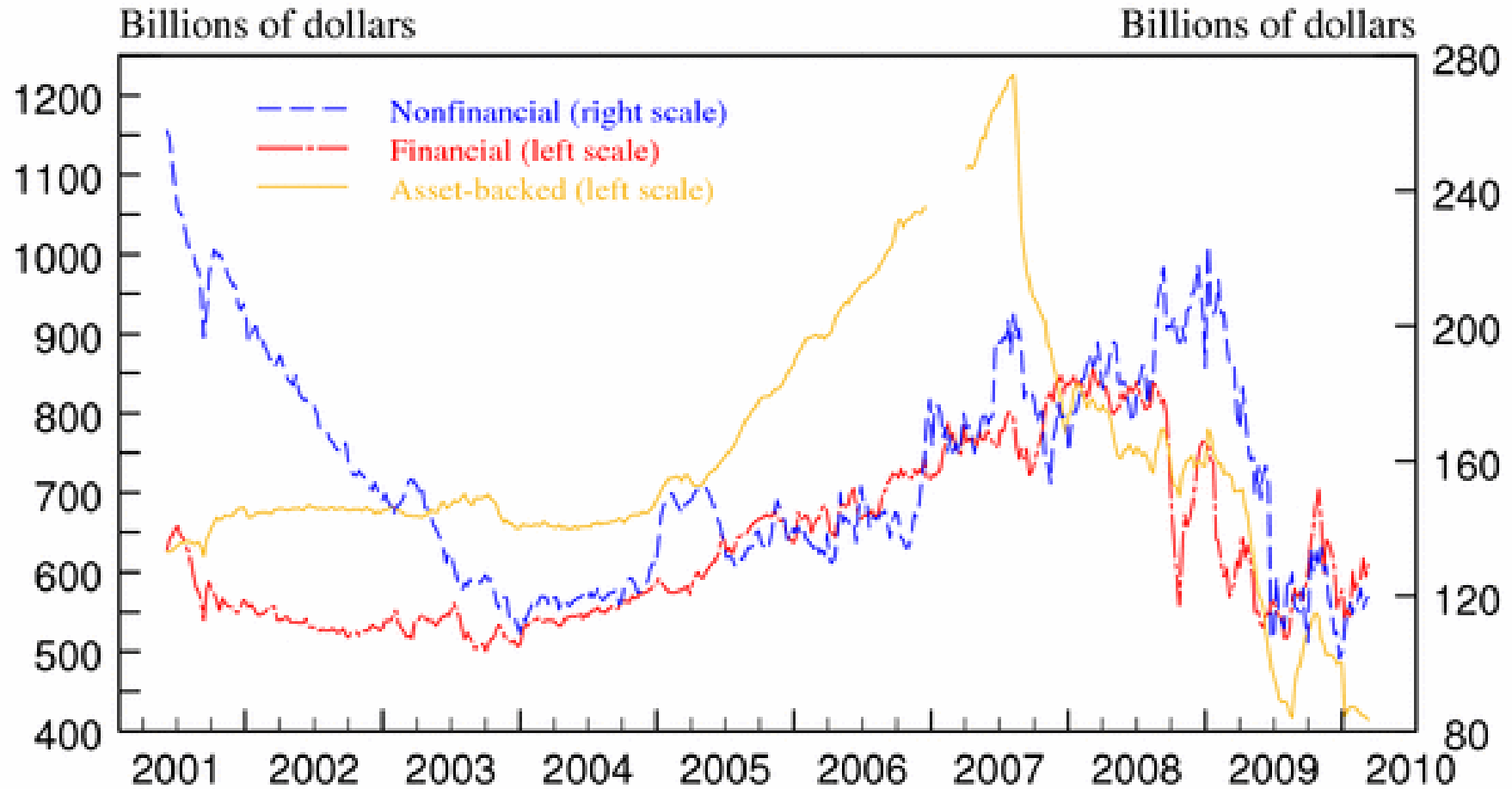
Source: BIS, Annual Report (2011)

Leverage (as of 2007)



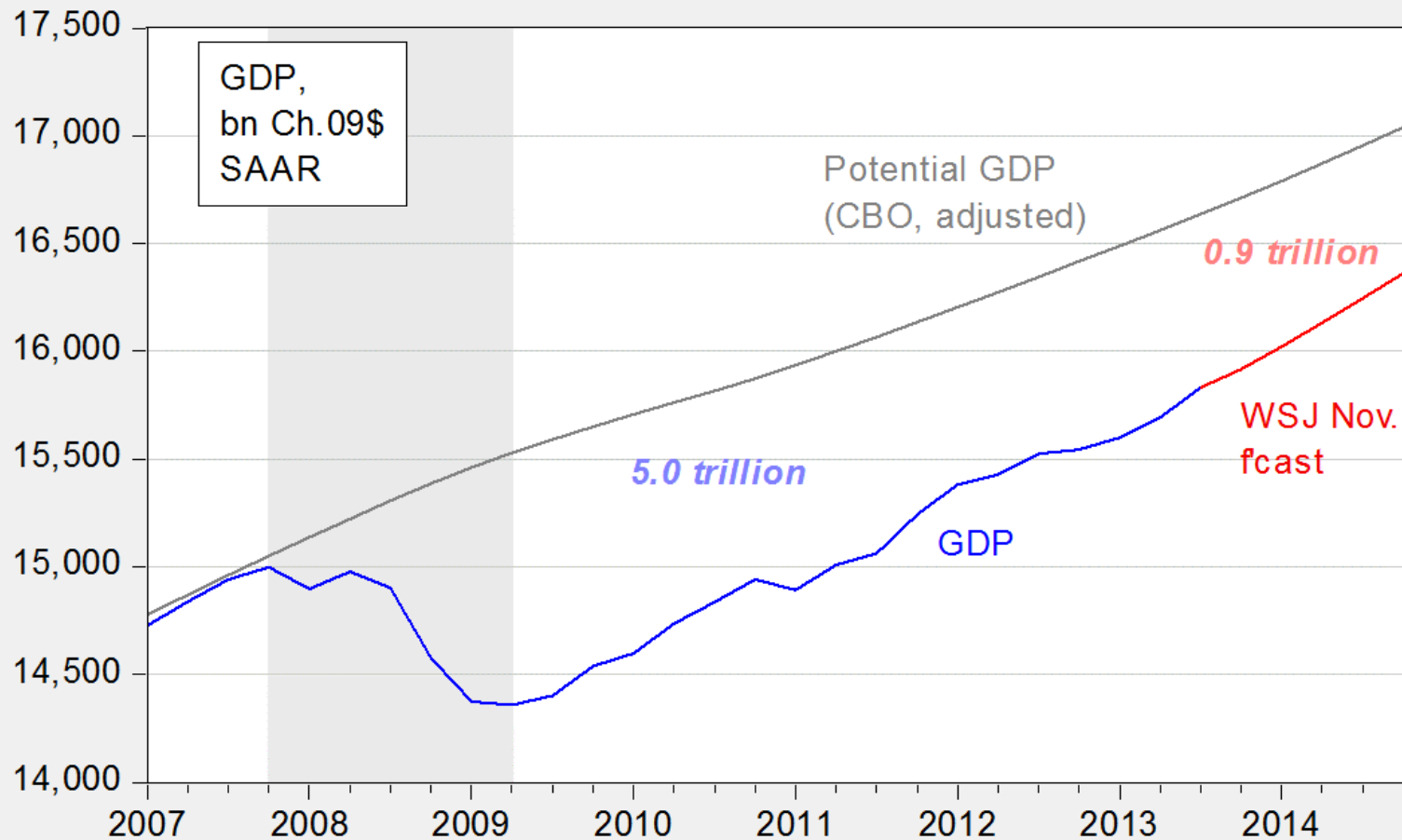
Source: Greenlaw, Hatzius, Kashyap, and Shin (2008)

Boom and Bust in the Shadow Financial System



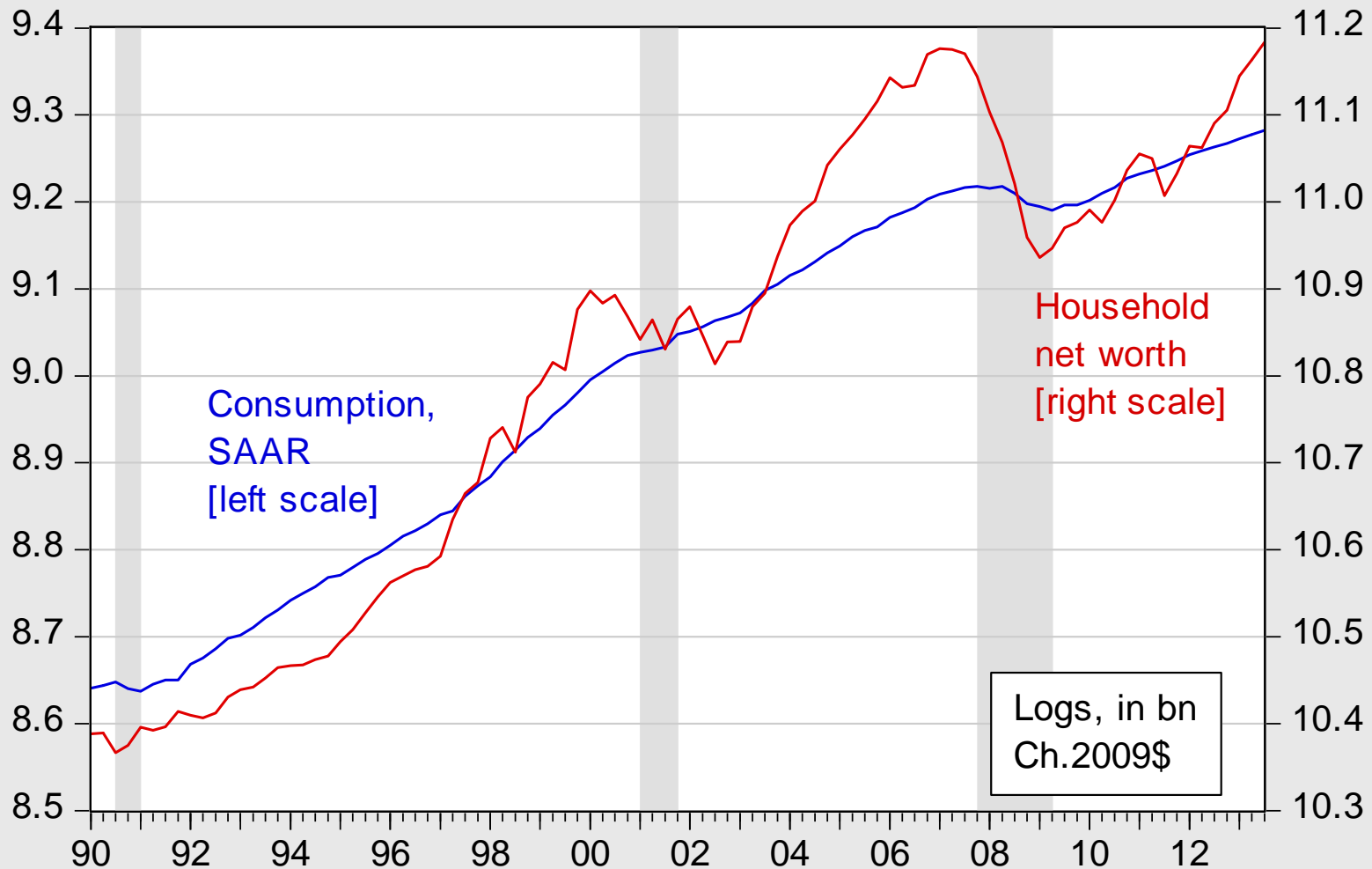
Source: Federal Reserve Board

Leading to Recession/Depression



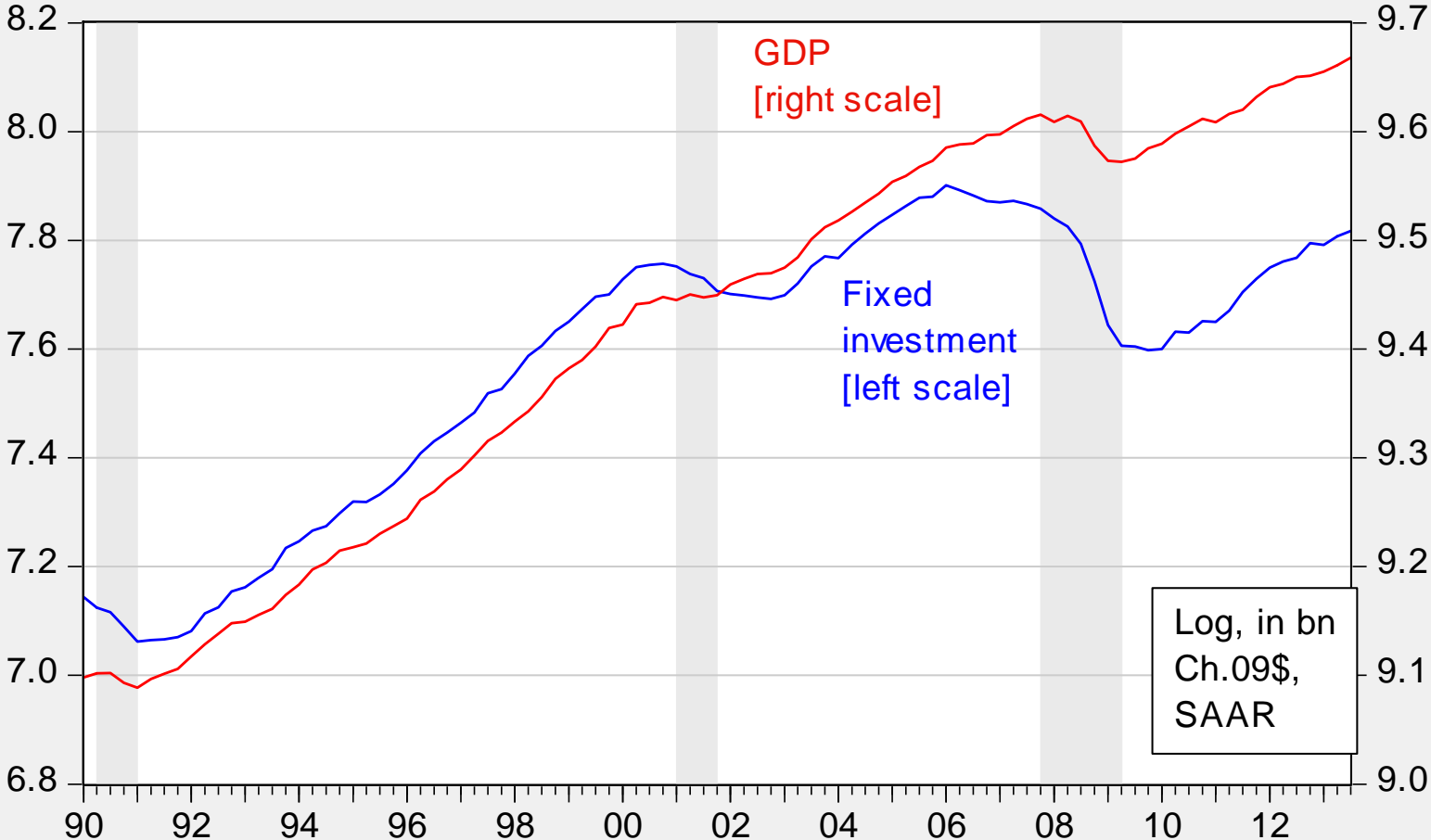
Source: BEA, 2012Q3 3rd release, CBO (Aug. 2012), *WSJ*

Consumption and Wealth



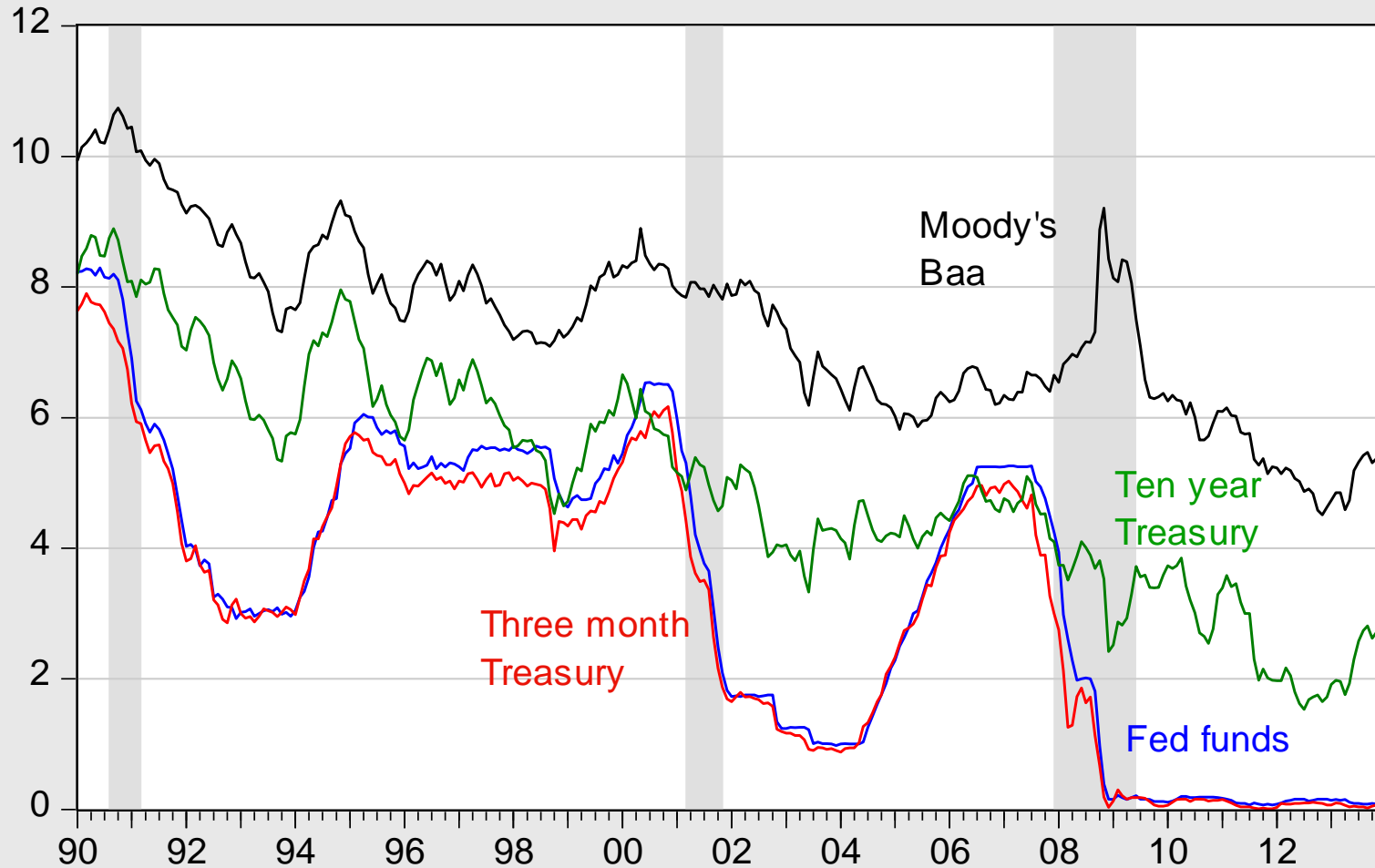
Source: BEA, 2013Q3 3rd release, Fed Flow of Funds

Investment



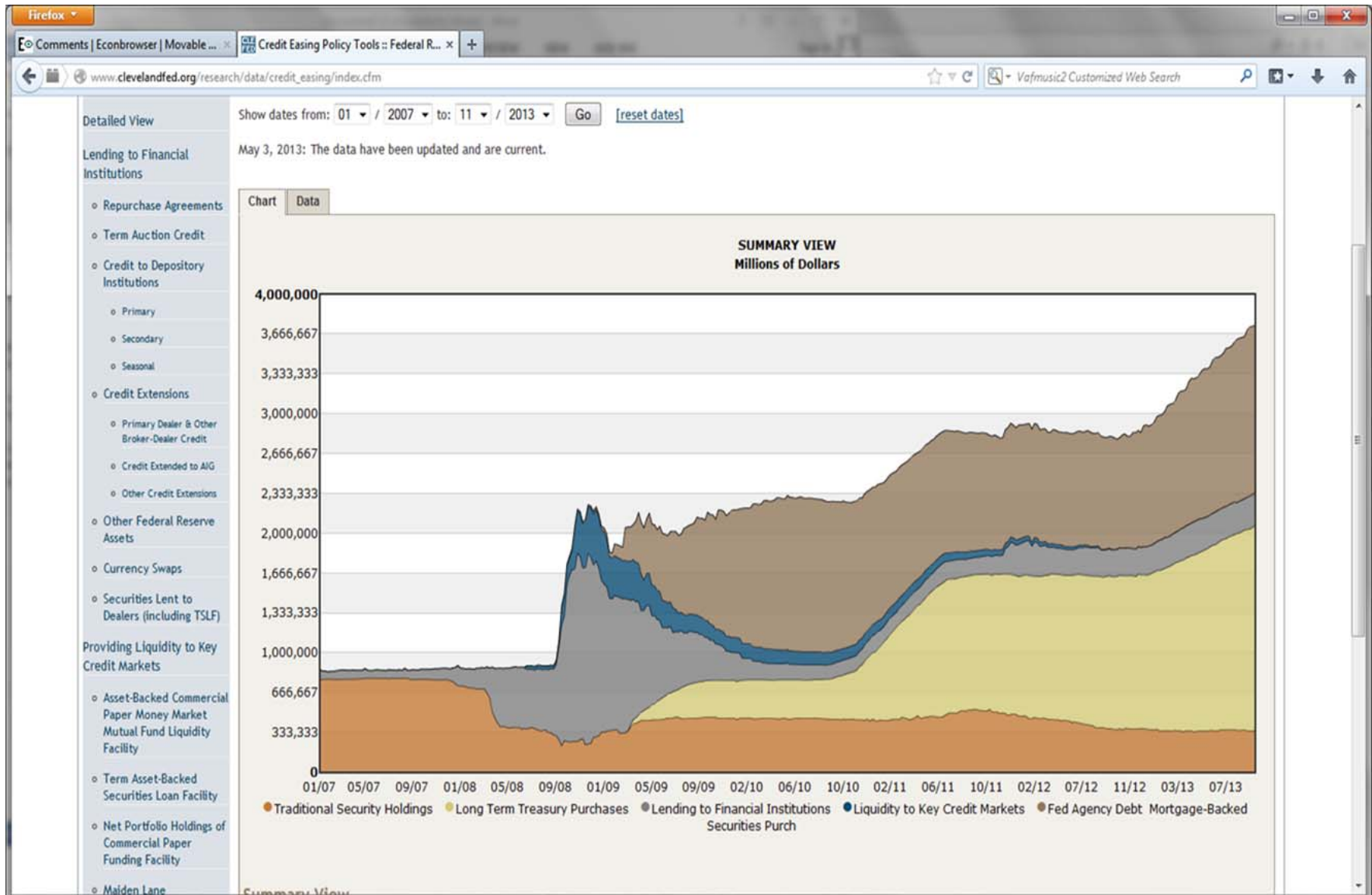
Source: BEA, 2013Q3 3rd release

Conventional Monetary Policy



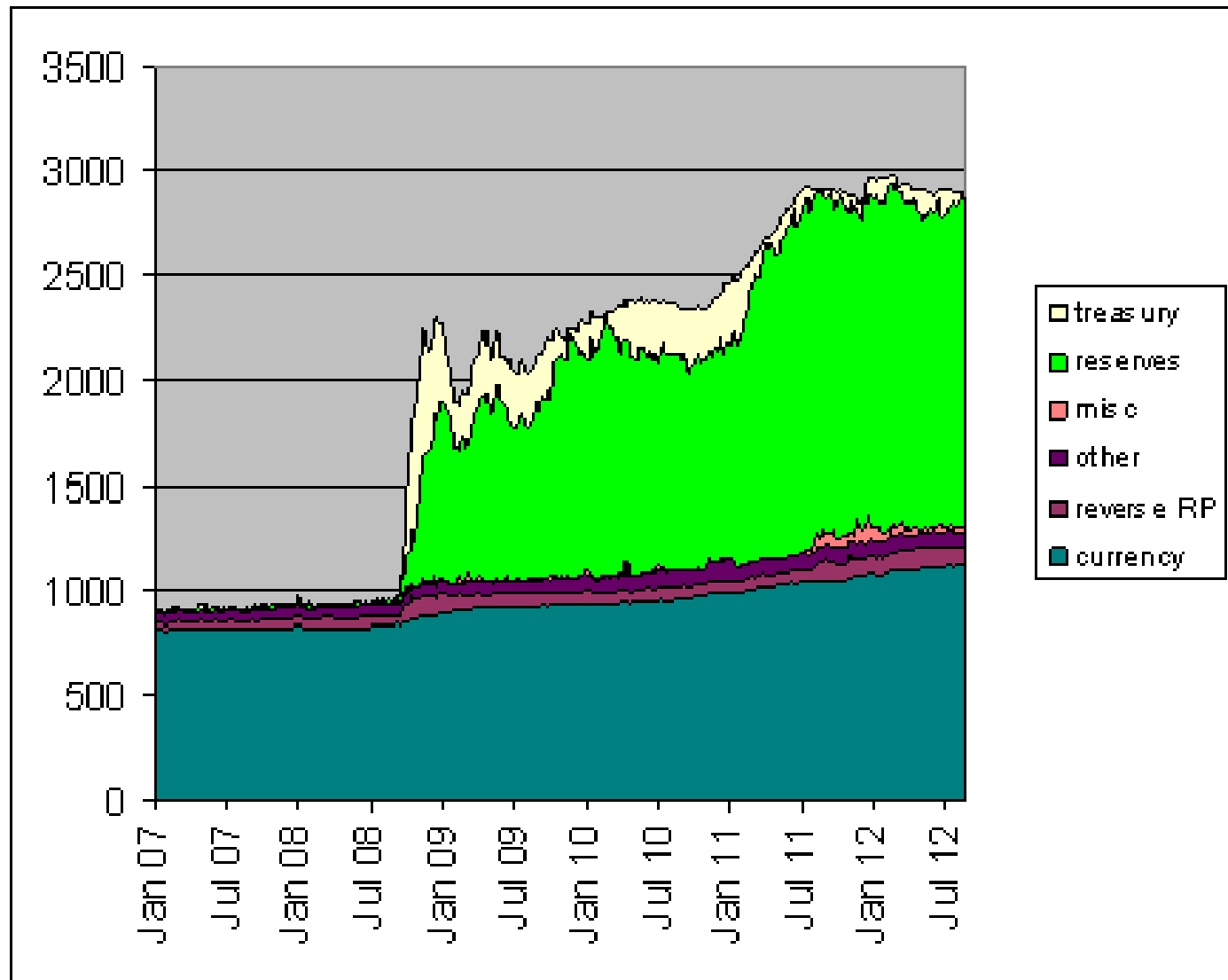
Source: St. Louis Fed FRED system

Quantitative Easing, Operation Twist

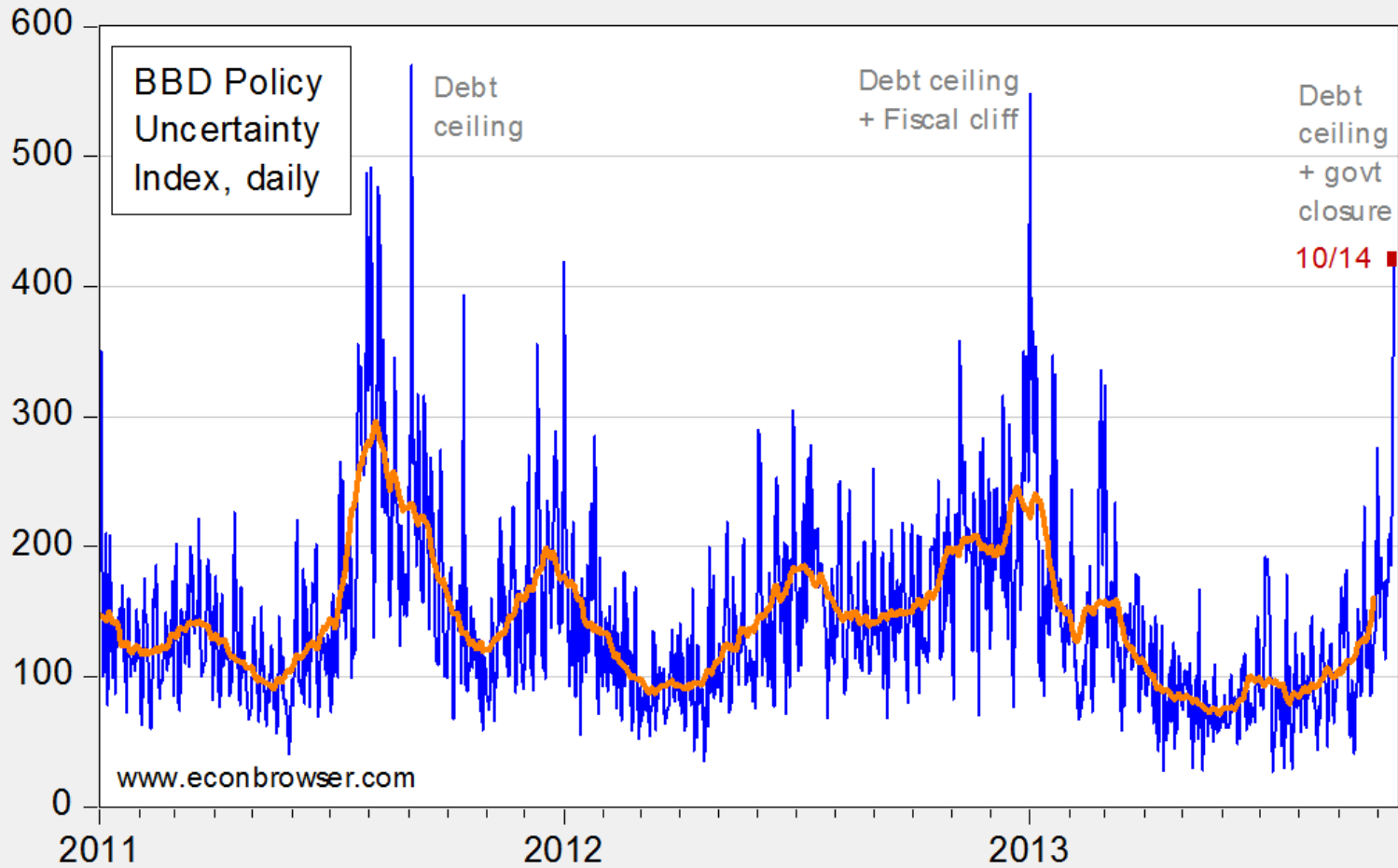


http://www.clevelandfed.org/research/data/credit_easing/index.cfm

The Other Side of the Fed Balance Sheet



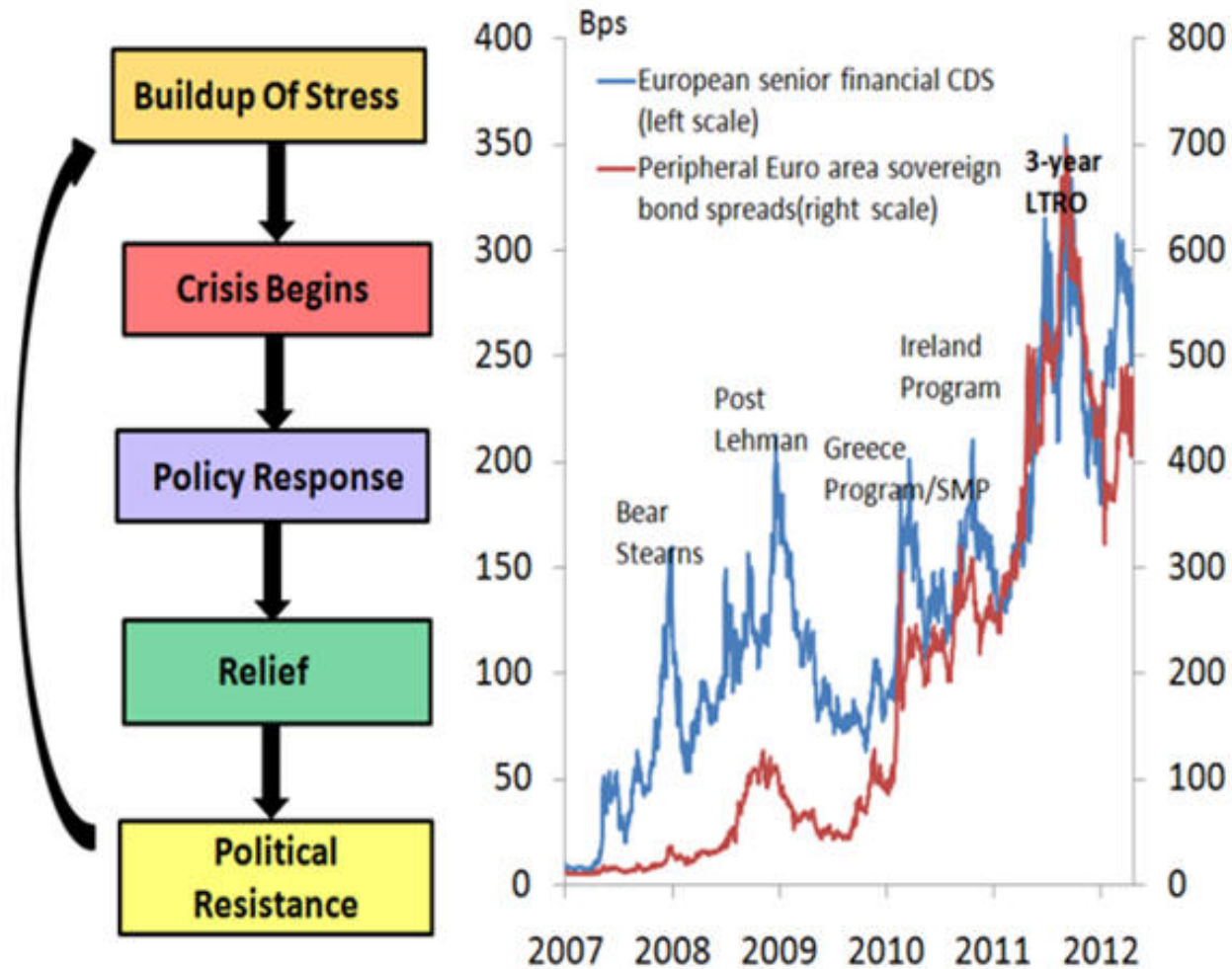
Policy Uncertainty



Source: Policy Uncertainty, <http://www.policyuncertainty.com>

Europe

Figure 1. The Escalating Cycle of Turmoil



Sources: Bloomberg L.P.; and IMF staff estimates.