

Economics 435  
The Financial System

Lecture 1

9/2/2014

Instructor: Prof. Menzie Chinn

UW Madison

Fall 2014

# Administrative Issues

- Course website:  
[http://www.ssc.wisc.edu/~mchinn/web435\\_f14.html](http://www.ssc.wisc.edu/~mchinn/web435_f14.html)
- OH: TuTh 1-2, 7418 Soc Sci
- Textbook: Chinn/Frieden, *Lost Decades*
- Cecchetti/Schoenholtz, or Mishkin
- Additional Readings: from web,  
Econbrowser, CBO
- *NYT, FT, WSJ, Economist*

# Administrative Issues

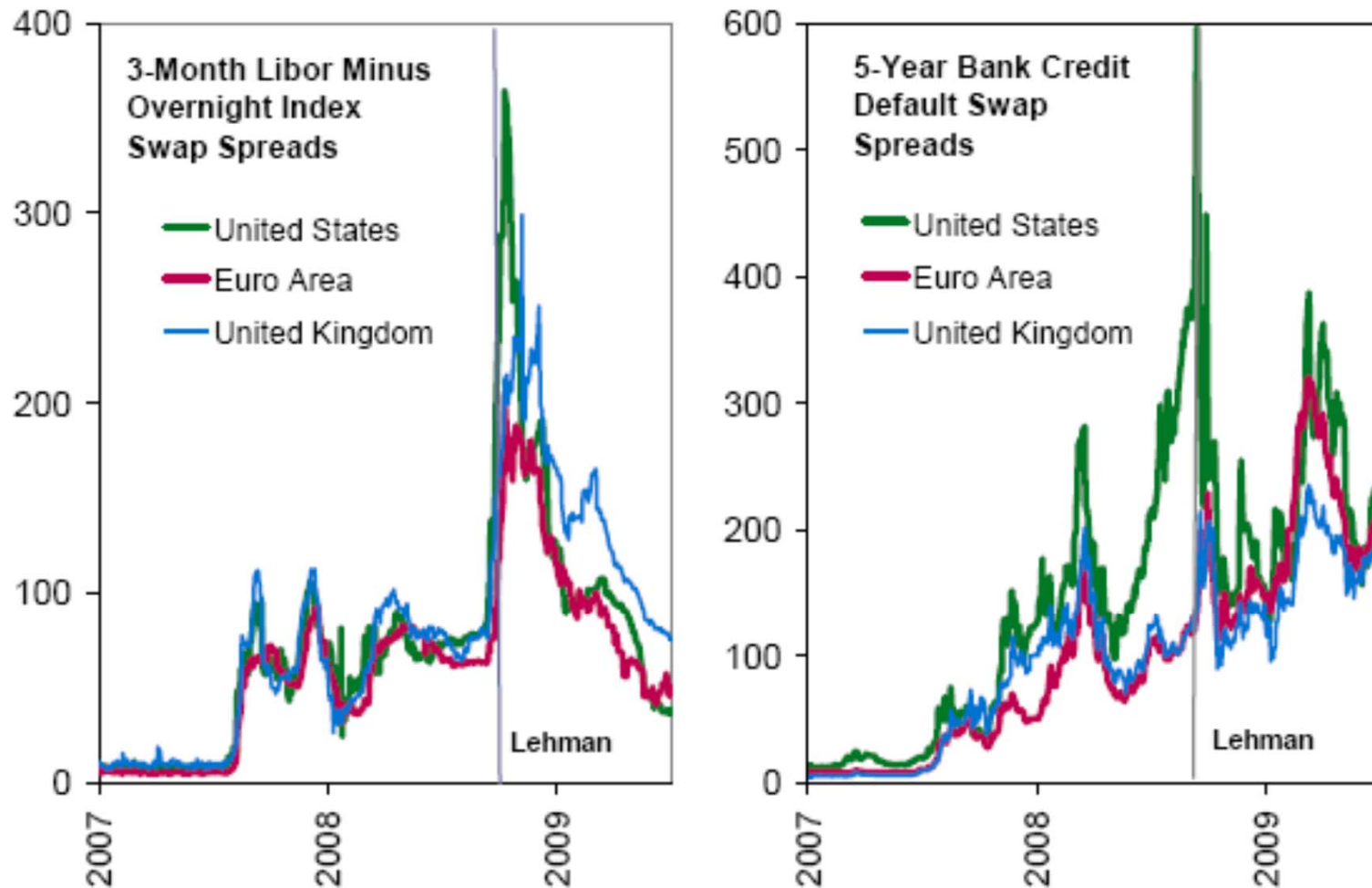
- Grading: 10% PS, 50% 2×MT, 40% paper
- Dates:
  - MT on 10/14, 11/20
  - **Paper due on Fri, 12/11**
- Make-ups: **None**. Points are re-allocated *if* you have a legitimate excuse. **No** late assignments accepted (must be handed in during lecture)

# Outline

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

# Risk and Crisis

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

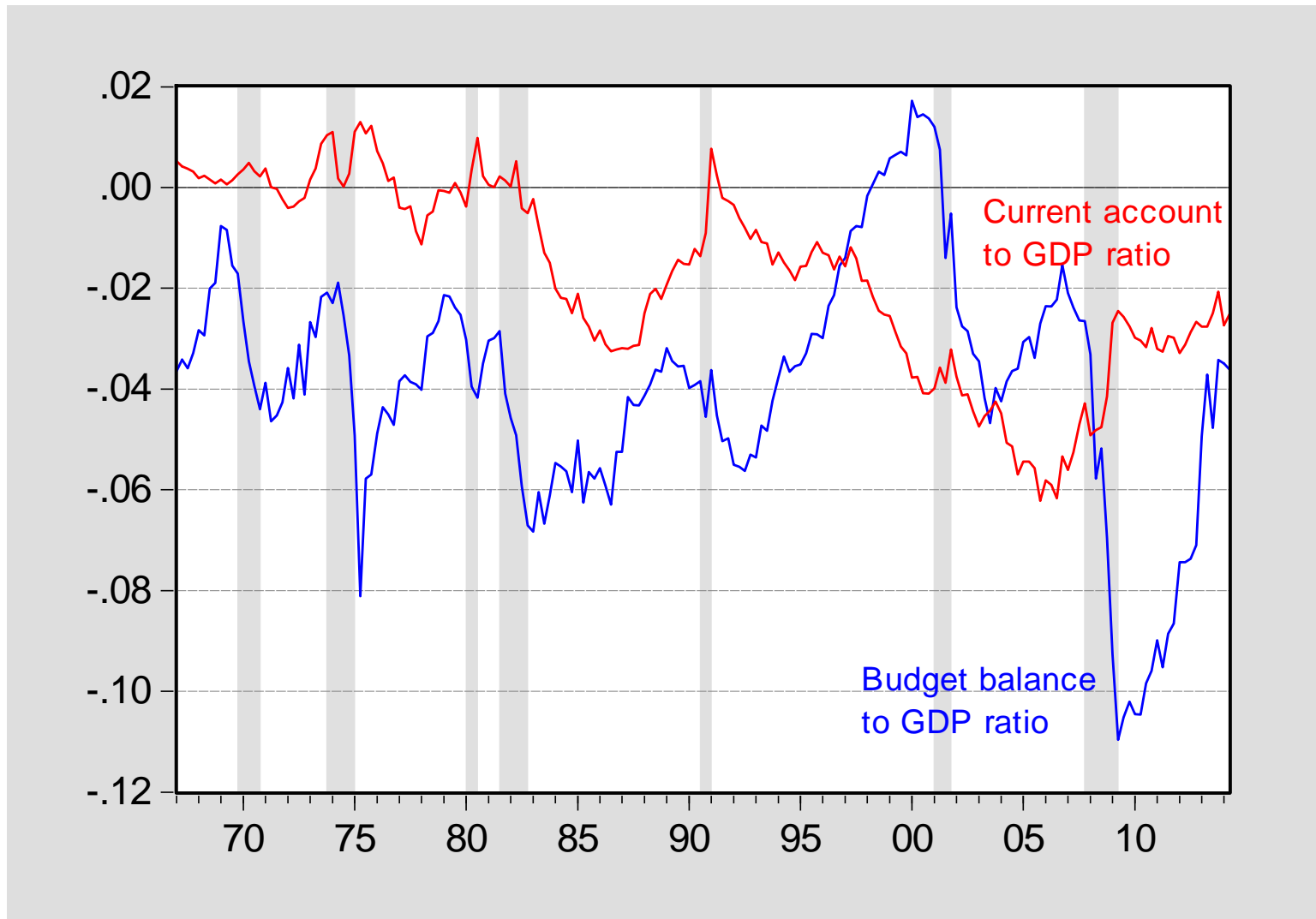


Sources: Bloomberg L.P.; and Datastream.

# 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



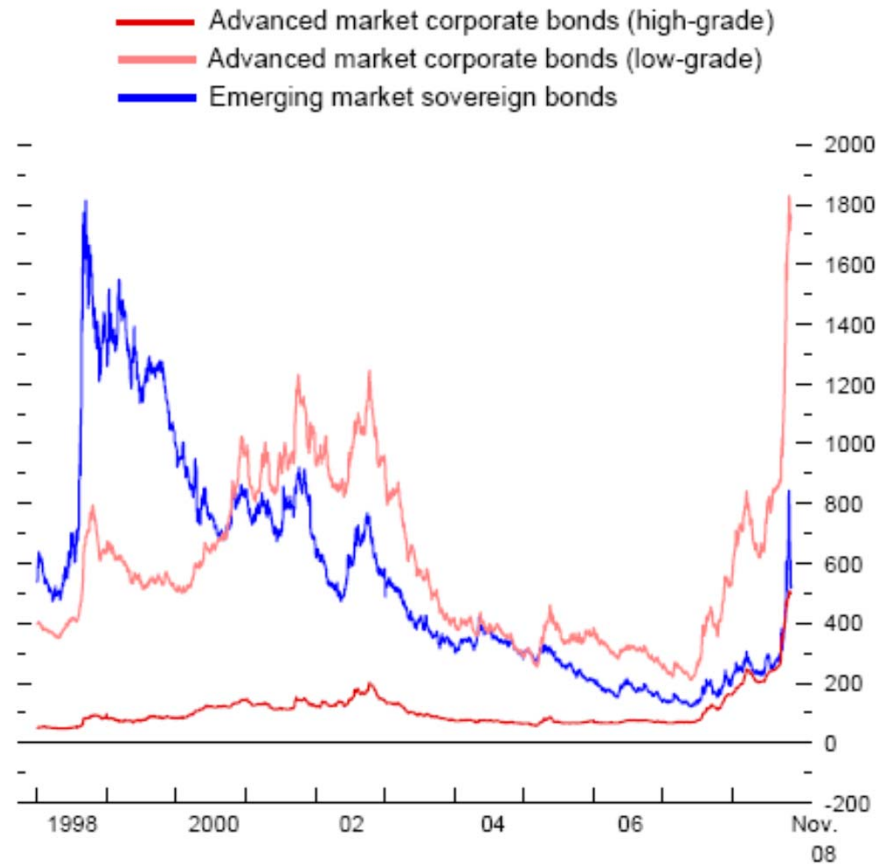
Source: Federal Reserve Board, Philadelphia Fed *SPF*



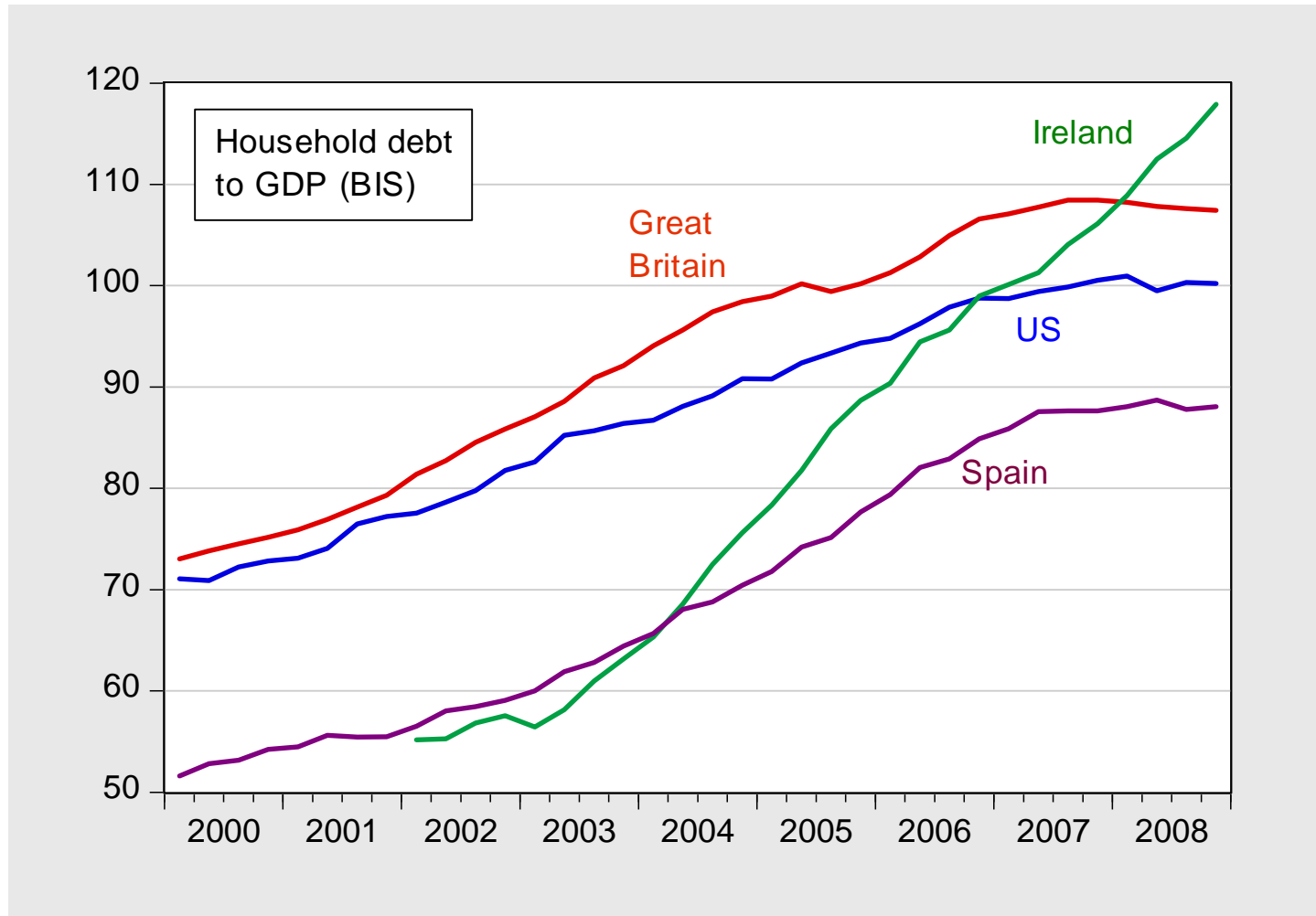
# The “Disappearance” of Risk

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

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

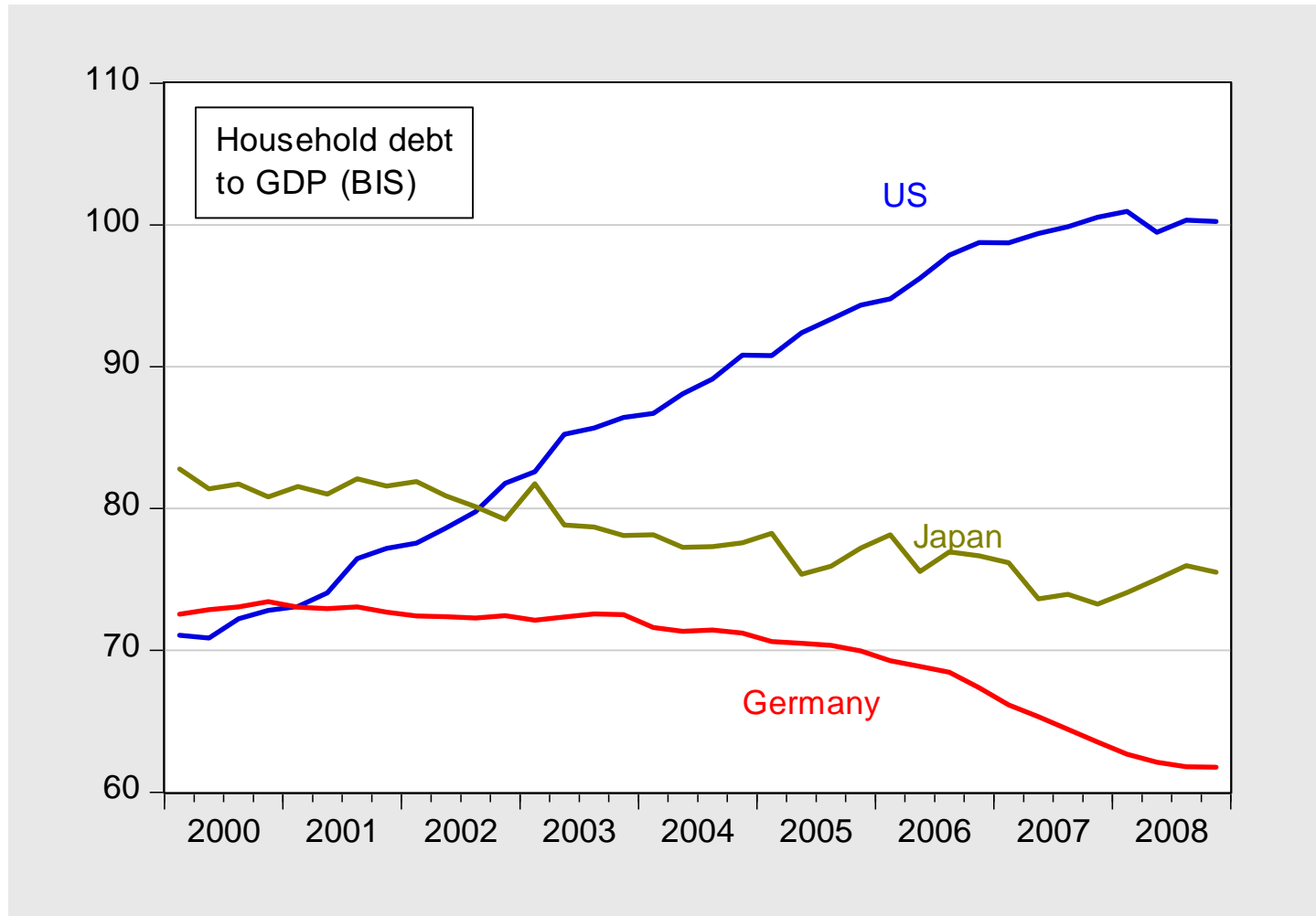


# Household debt (I)



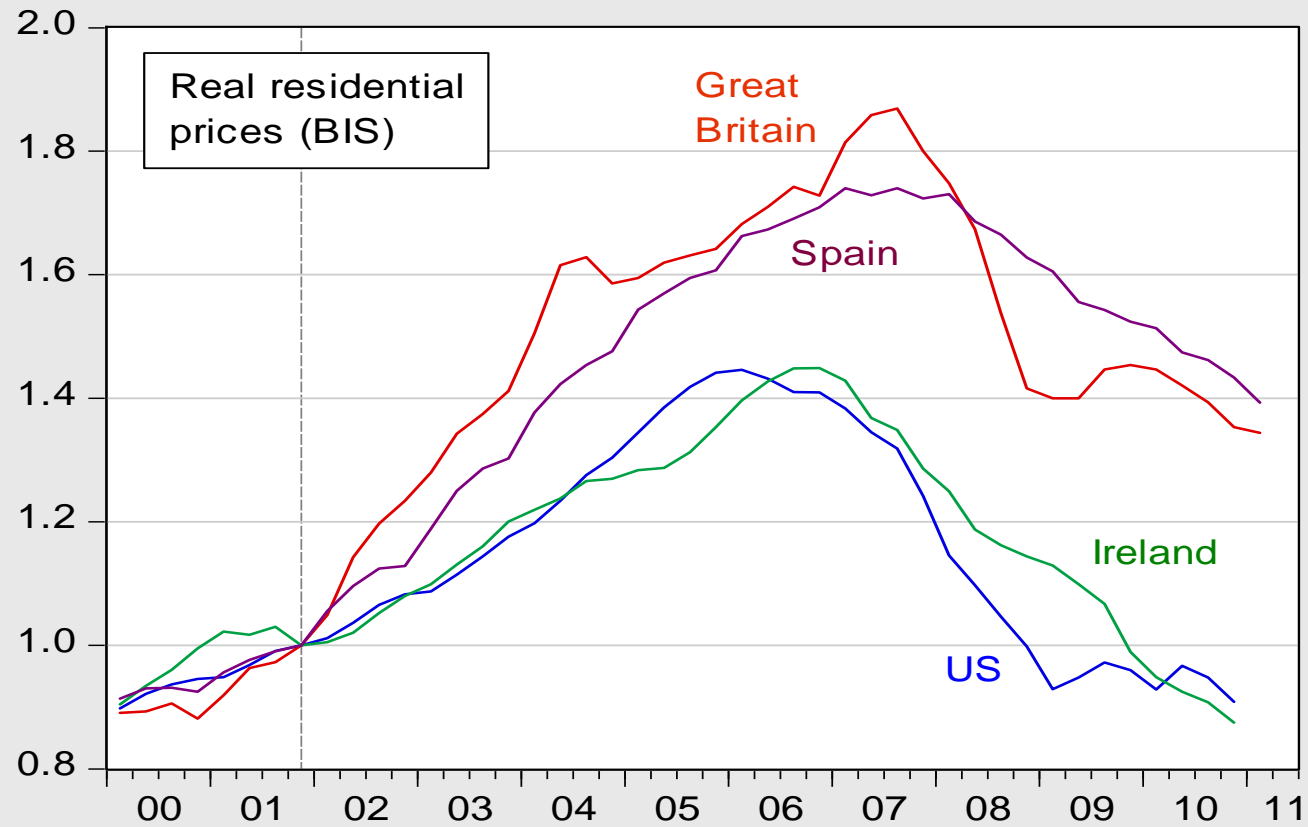
Source: BIS, *Annual Report* (2011)

# Household debt (II)



Source: BIS, *Annual Report* (2011)

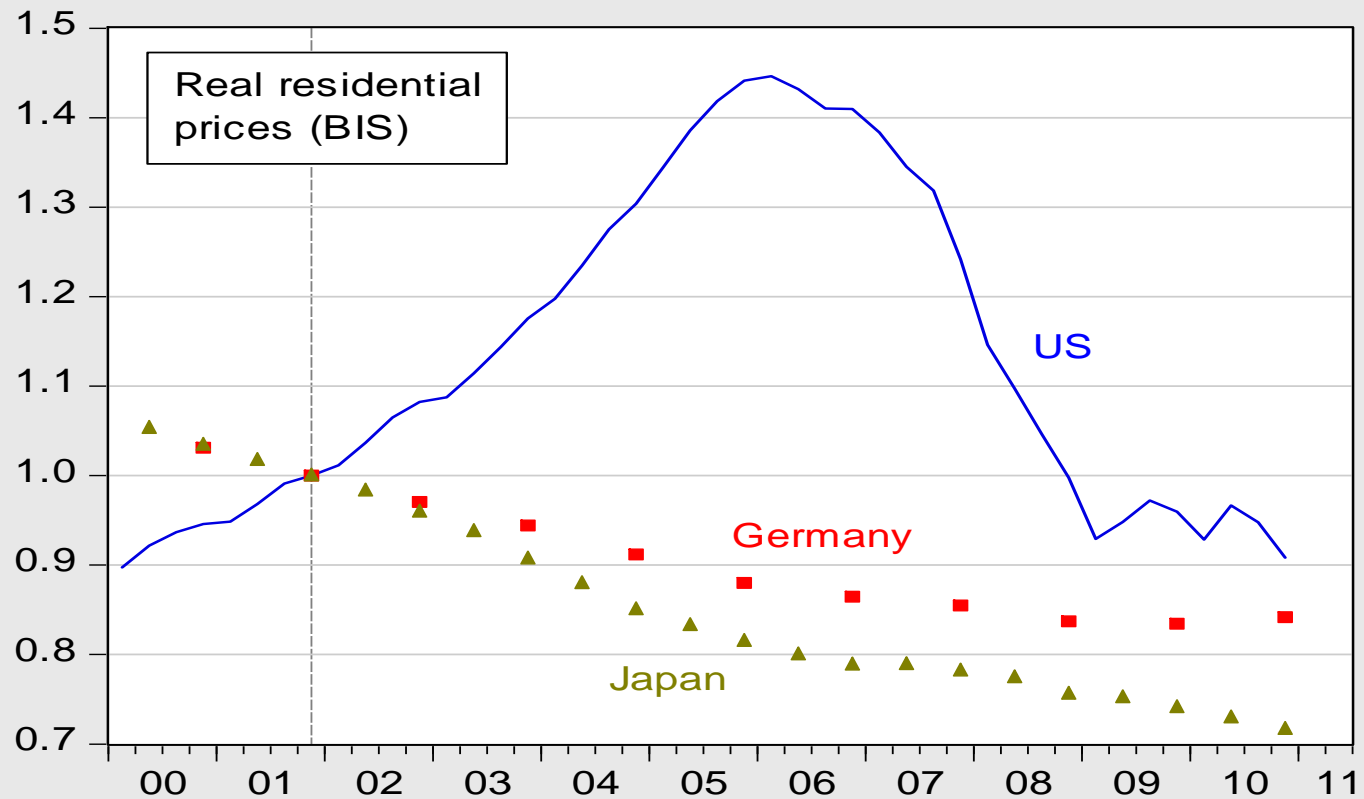
# Housing boom (I)



Note: Rescaled to 2001Q4=1.

Source: BIS, Annual Report (2011)

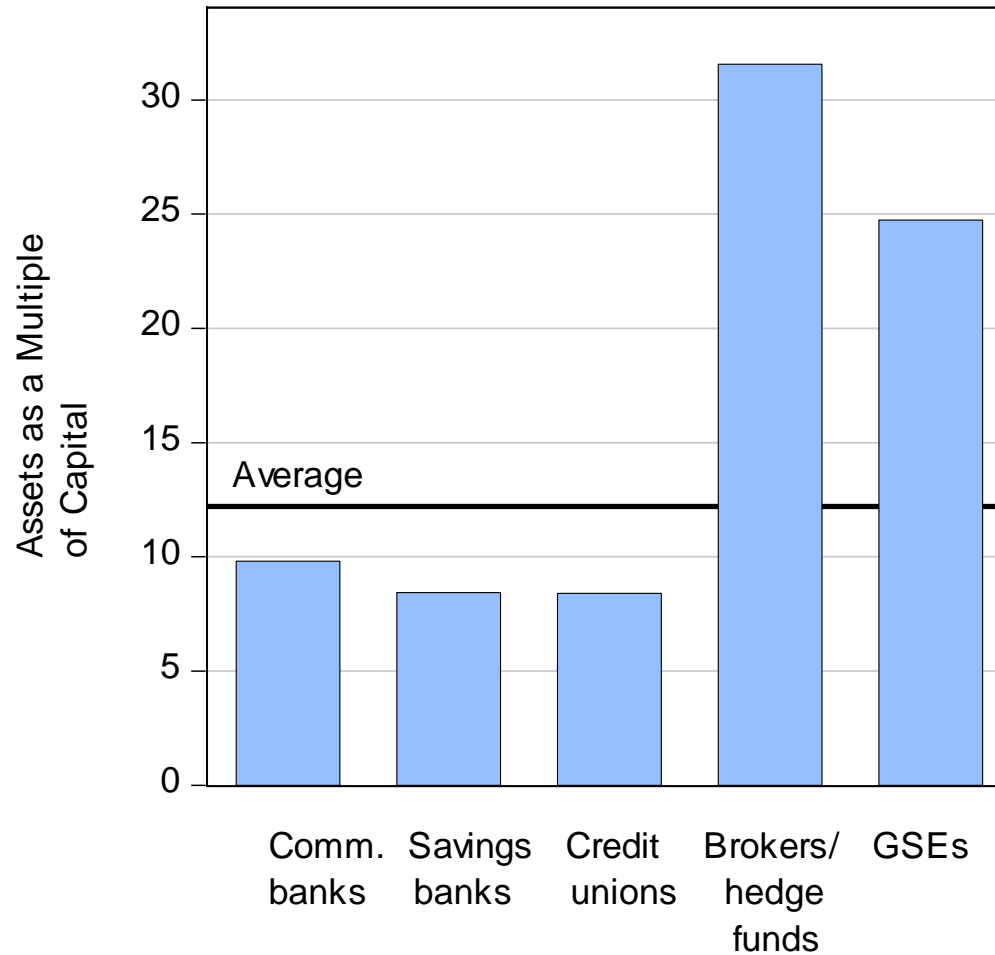
# Housing boom (II)



Note: Rescaled to 2001Q4=1.

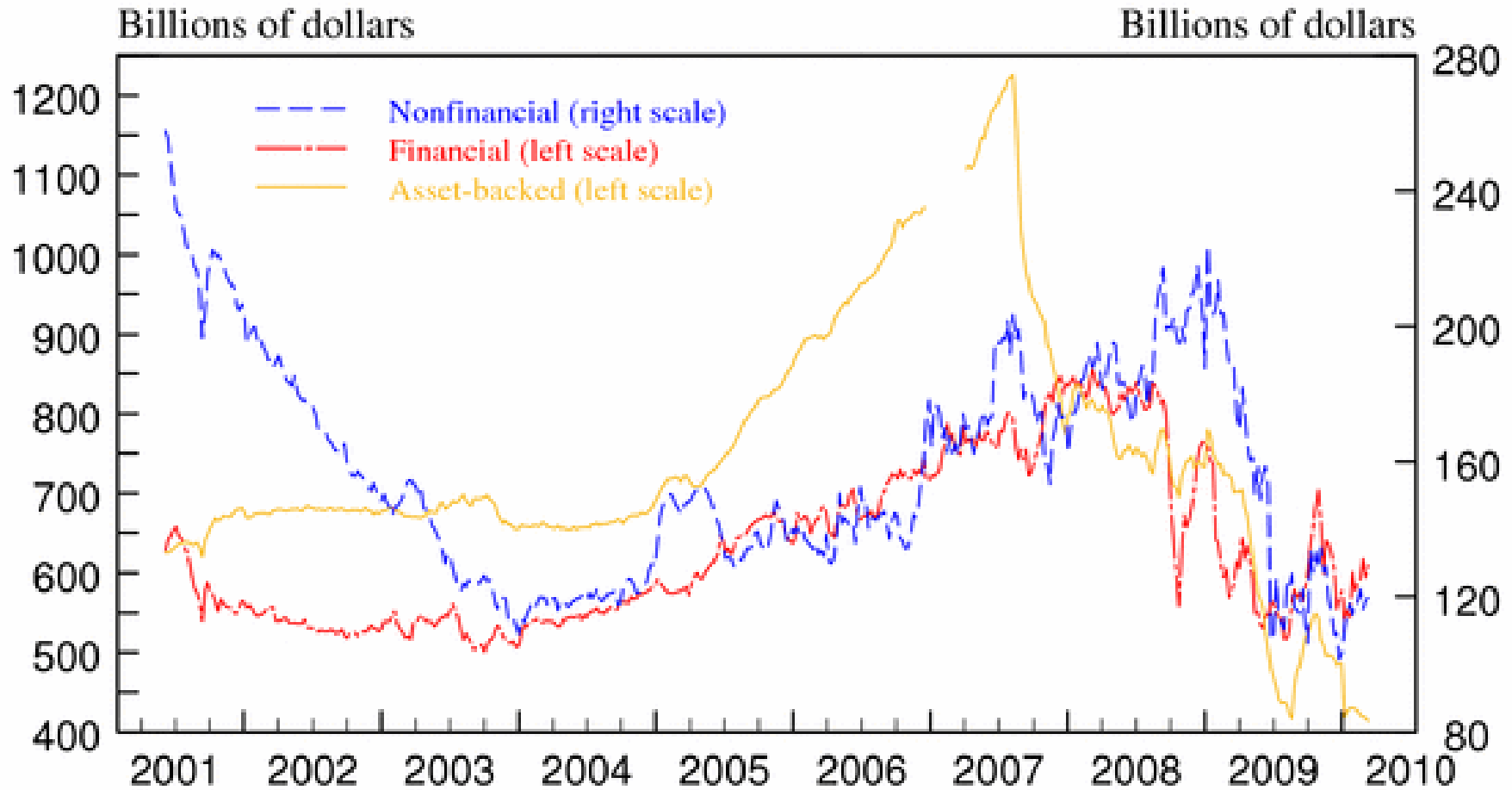
Source: BIS, Annual Report (2011)

# Leverage (as of 2007)



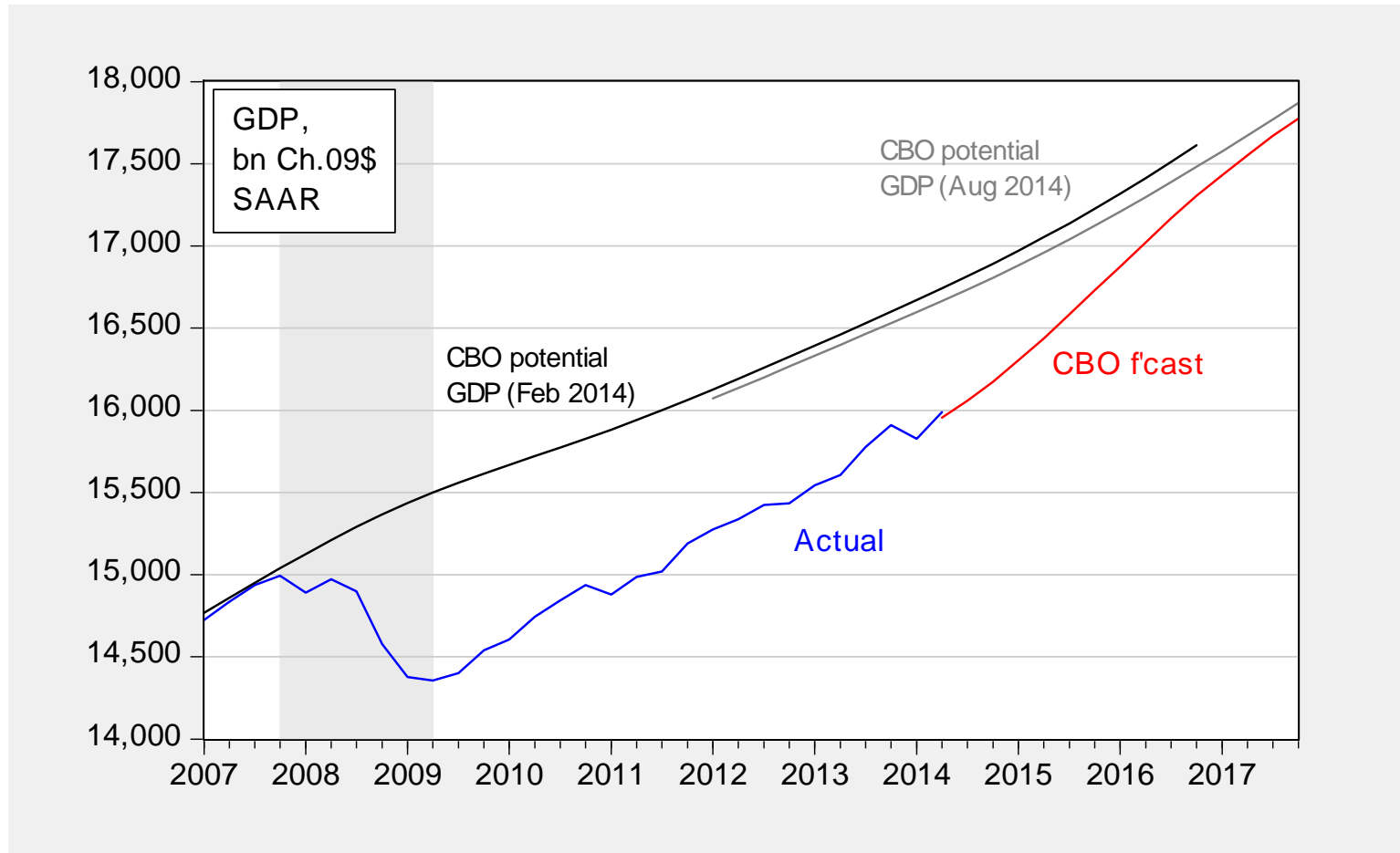
Source: Greenlaw, Hatzius, Kashyap, and Shin (2008)

# Boom and Bust in the Shadow Financial System



Source: Federal Reserve Board

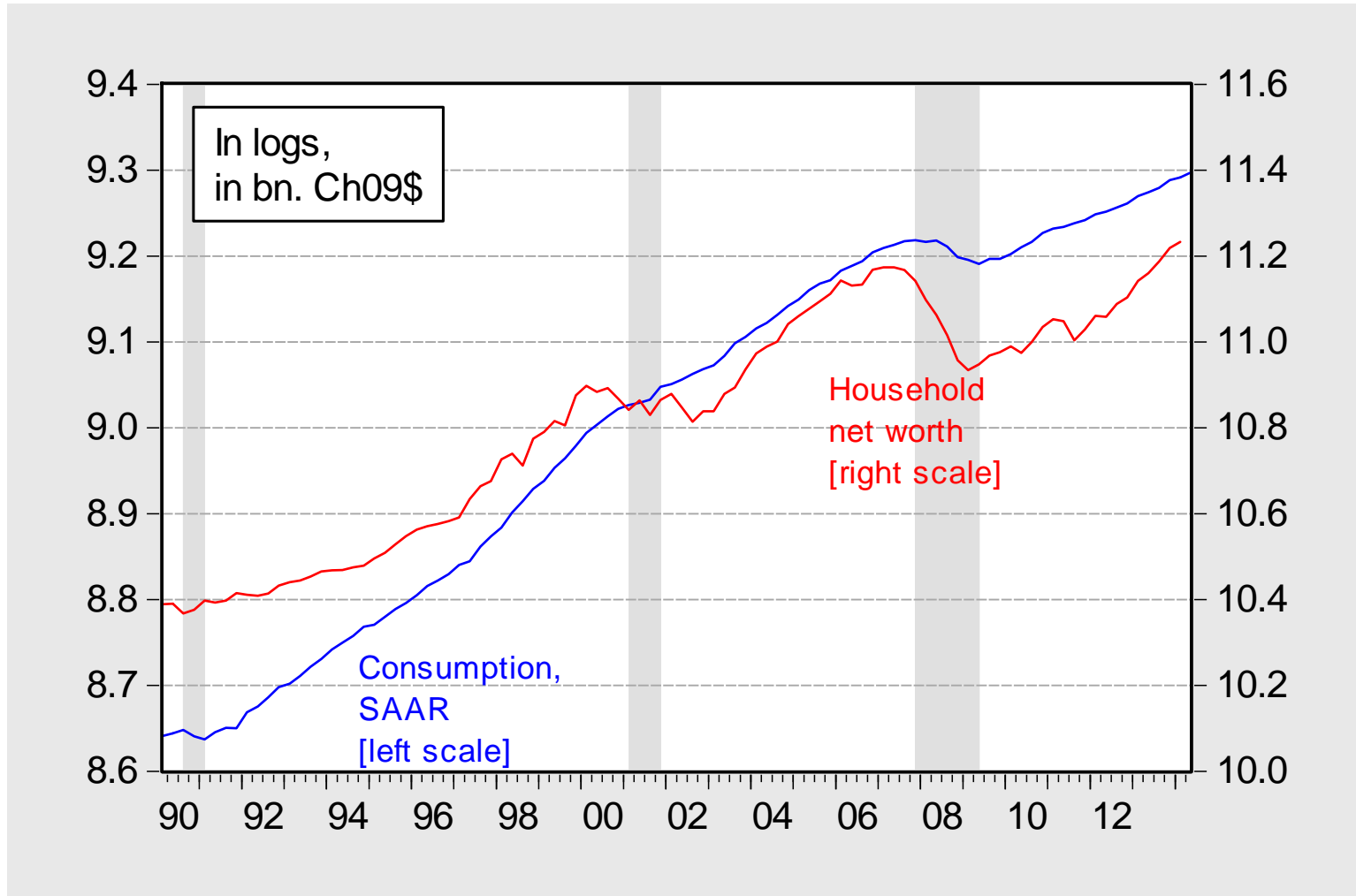
# Leading to Recession/Depression



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

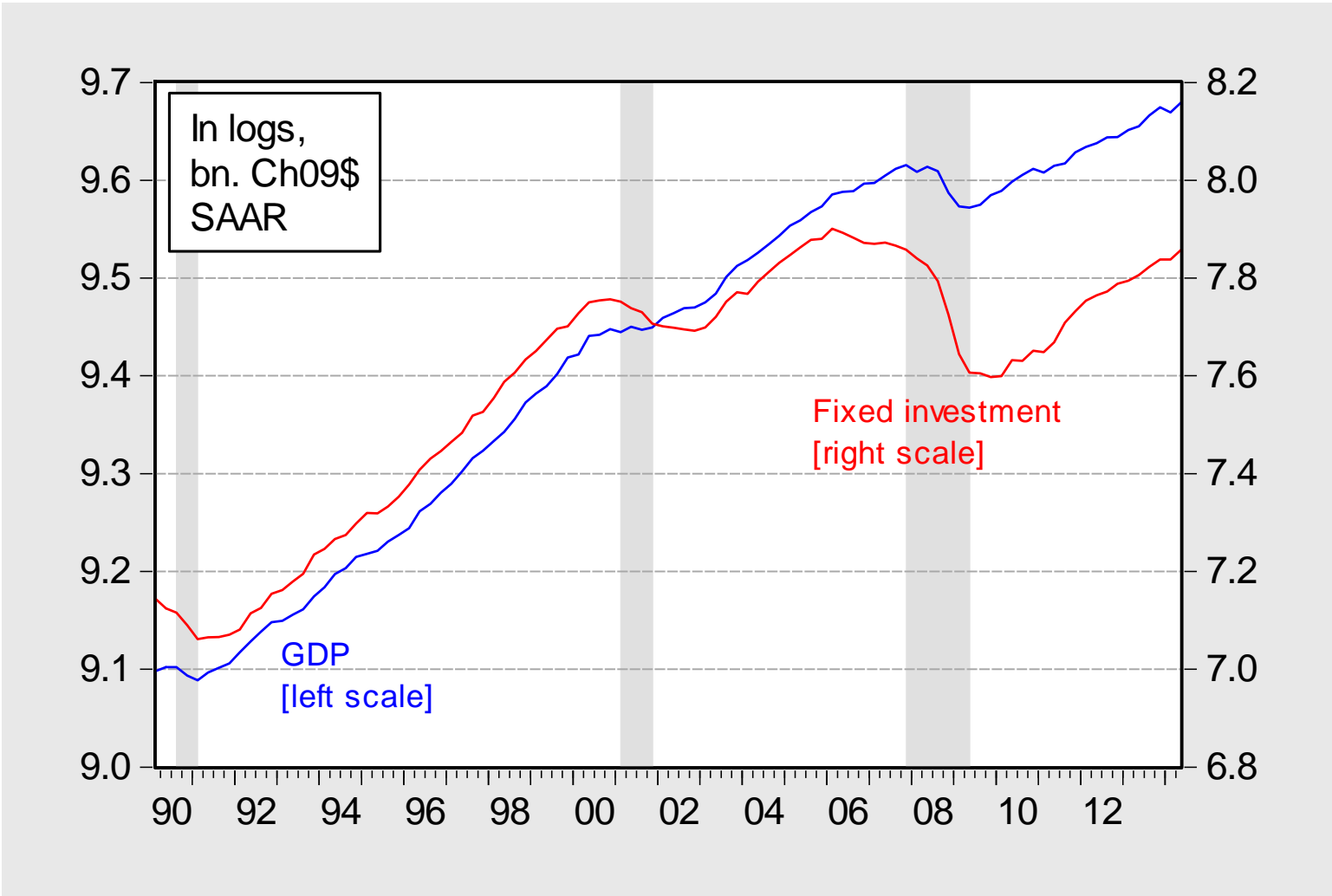


# Consumption and Wealth



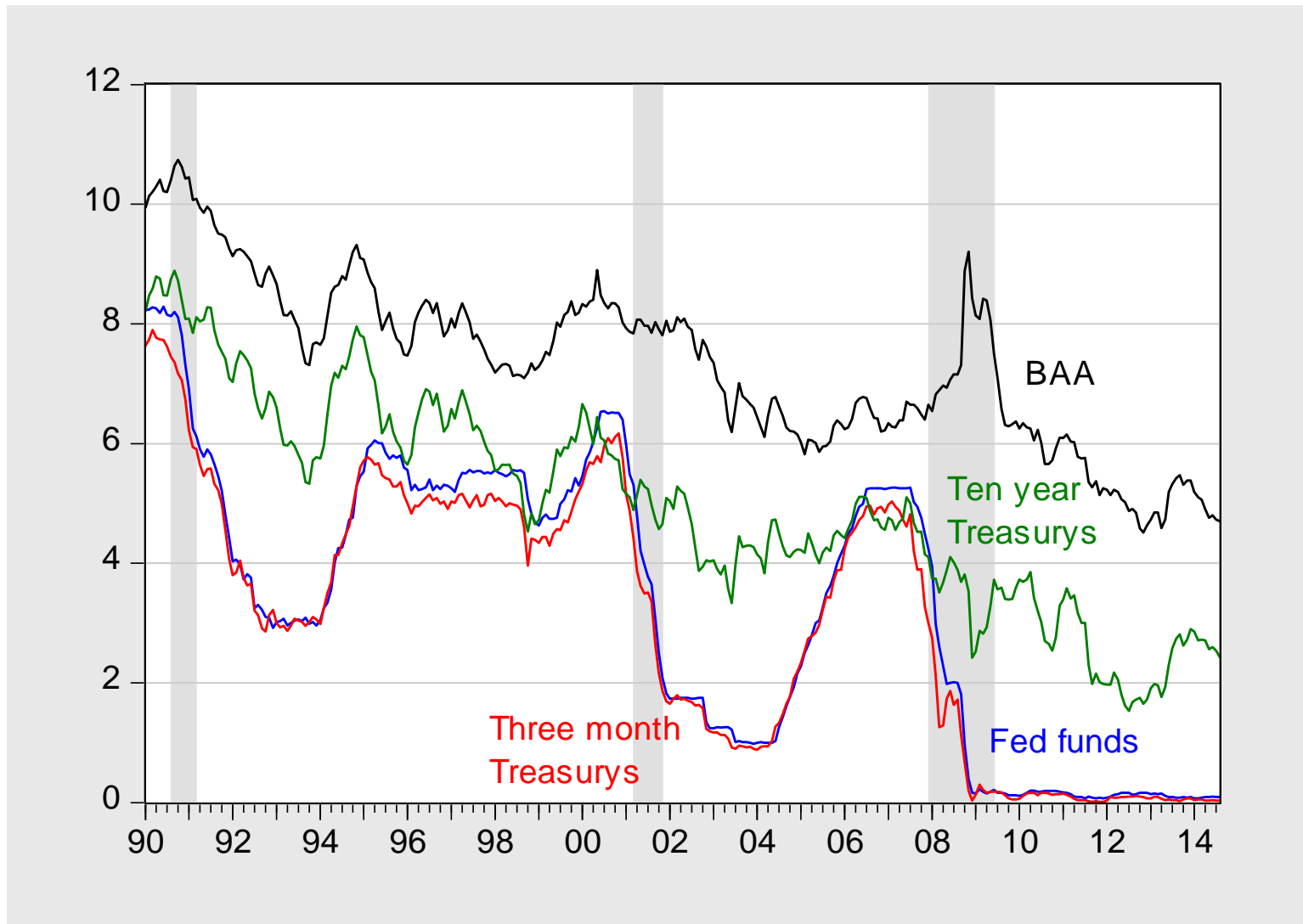
Source: BEA, 2014Q2 2nd release, Fed Flow of Funds

# Investment



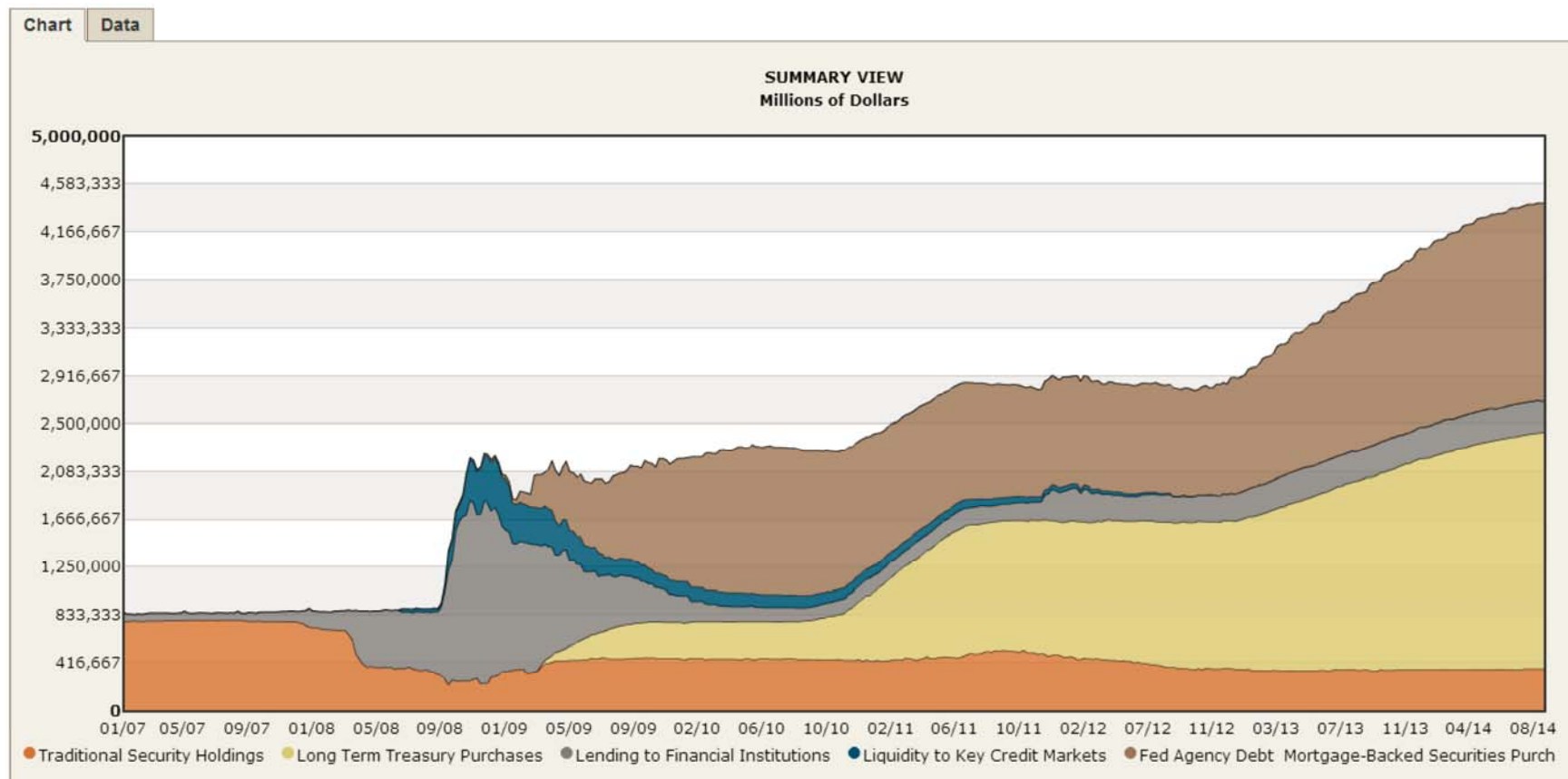
Source: BEA, 2013Q3 3<sup>rd</sup> release

# Conventional Monetary Policy



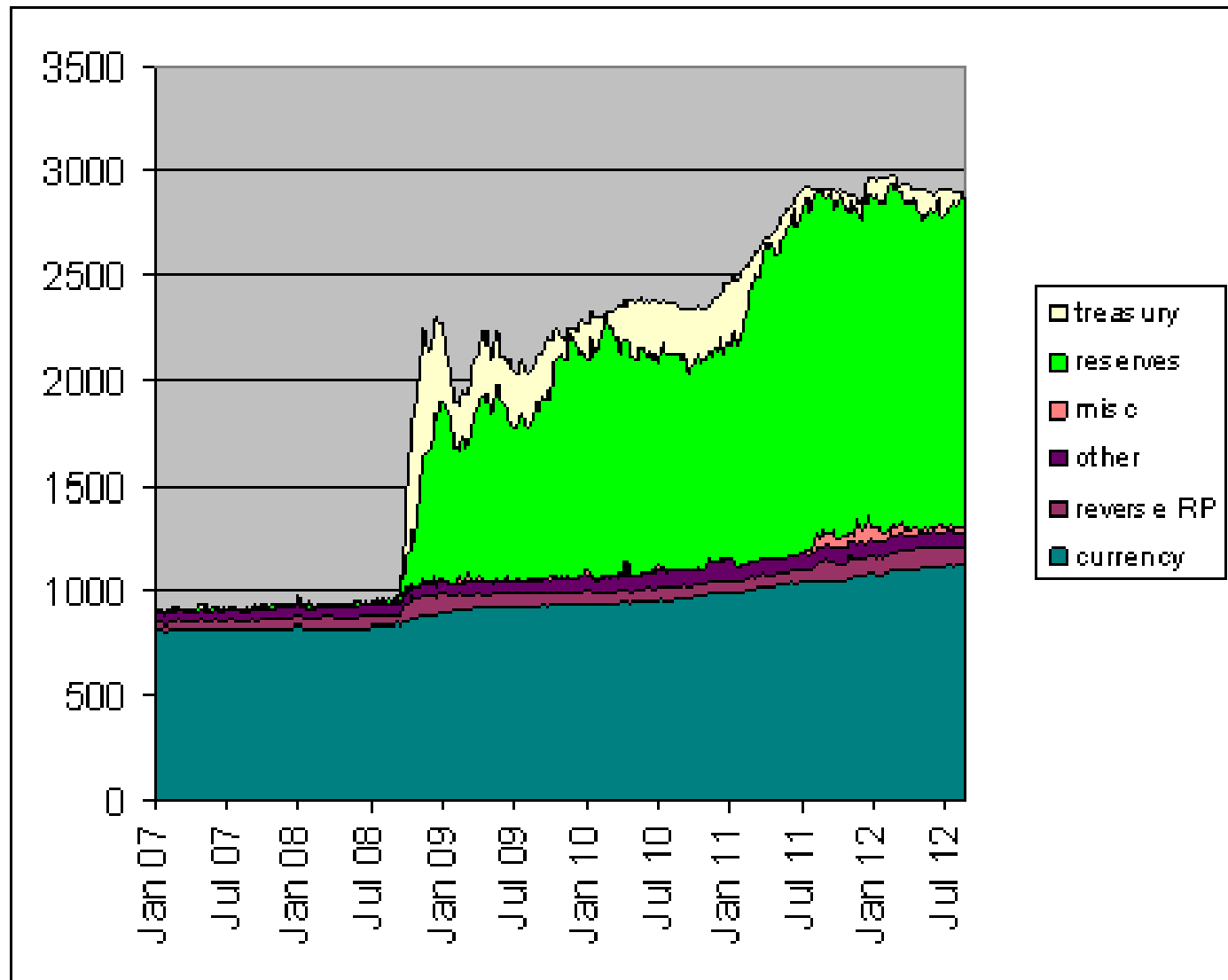
Source: St. Louis Fed FRED system

# Quantitative Easing, Operation Twist

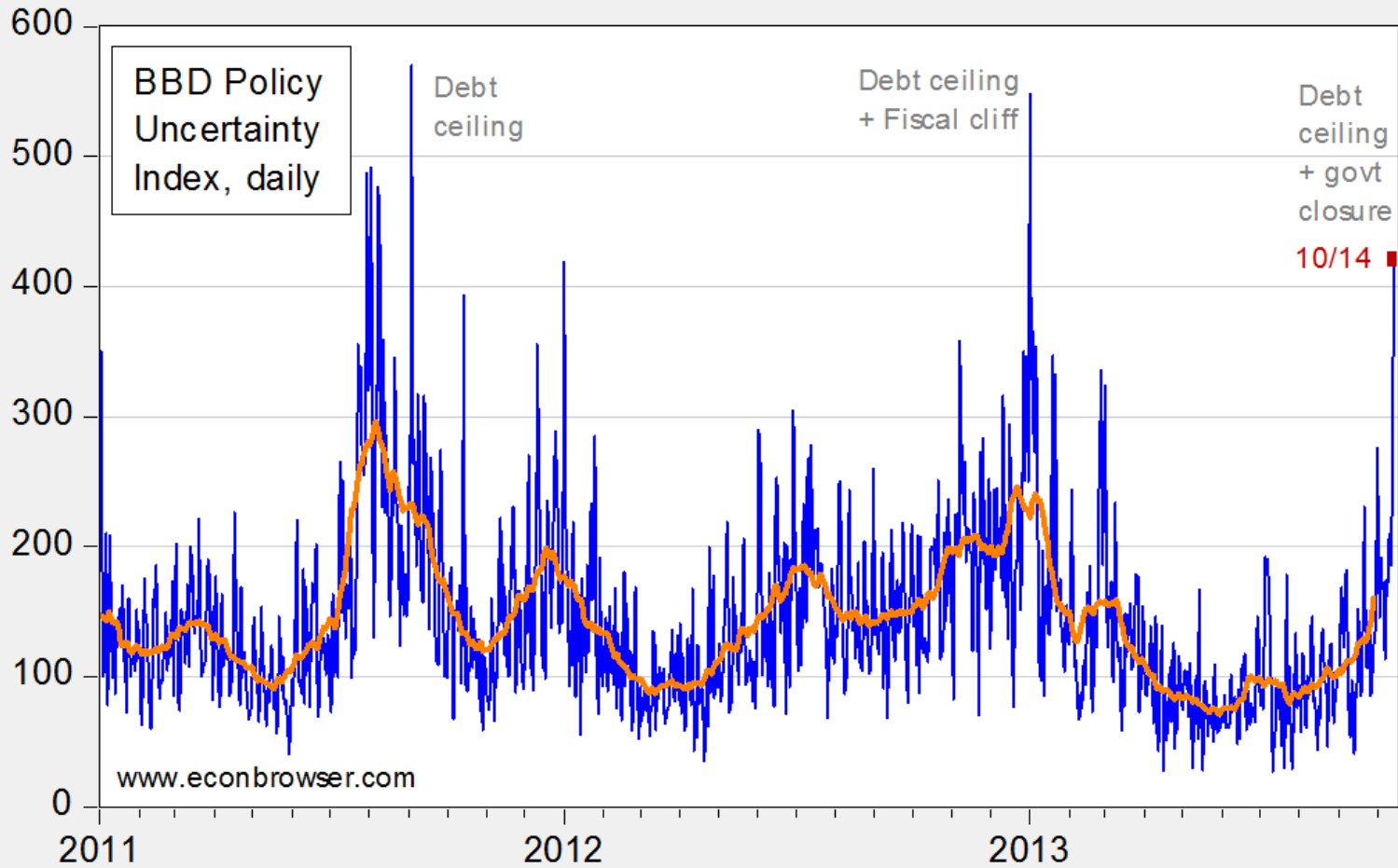


[http://www.clevelandfed.org/research/data/credit\\_easing/index.cfm](http://www.clevelandfed.org/research/data/credit_easing/index.cfm)

# The Other Side of the Fed Balance Sheet



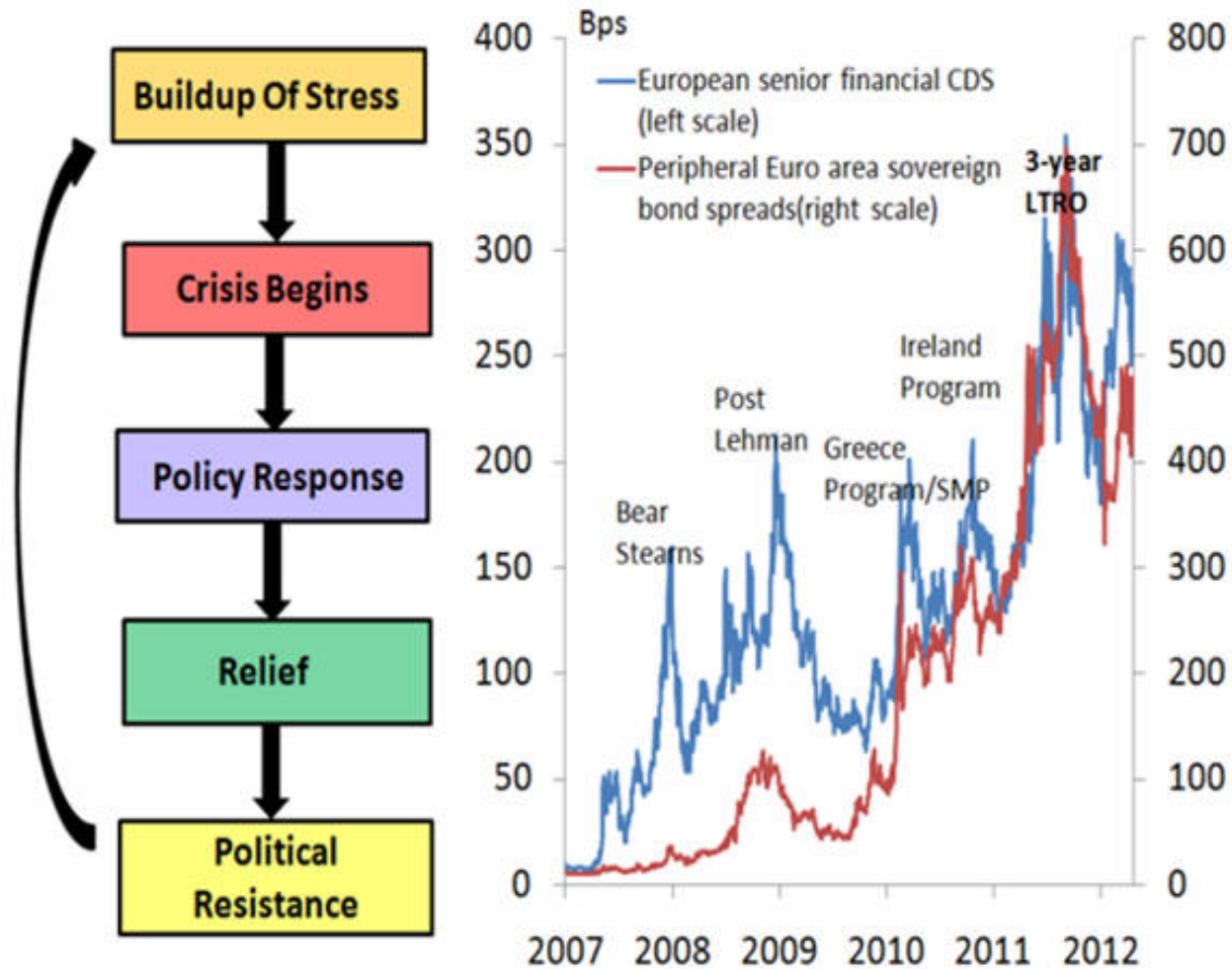
# Policy Uncertainty



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

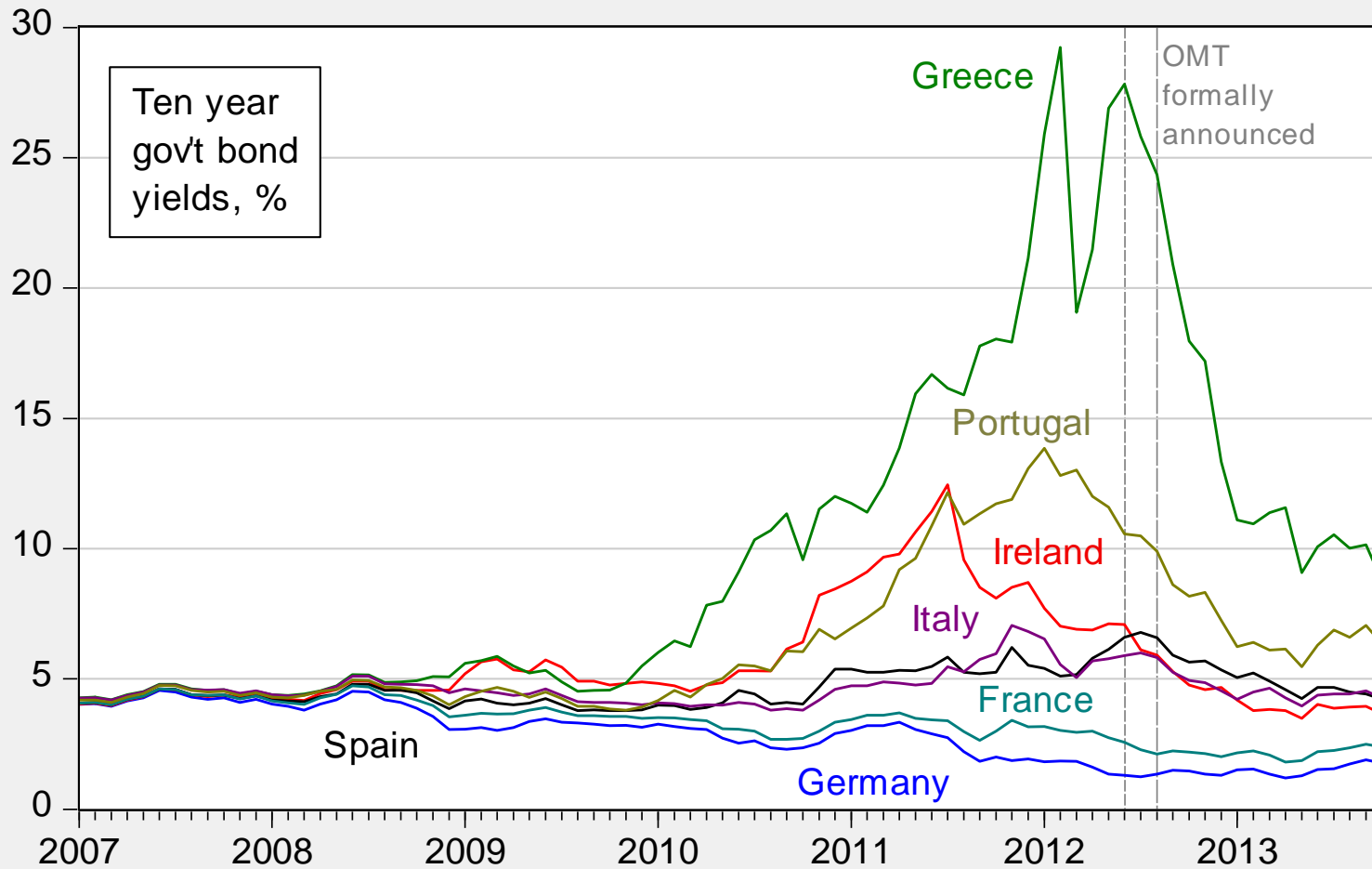
# Europe

Figure 1. The Escalating Cycle of Turmoil



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

# ECB Drives Down Sovereign Yields



Source: ECB



# The Current Puzzle

