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Economic and financial crises, an overview

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Today's presentation

- Introduction
- For reference – the ”ideal” economy (101 economics)
- Economic ups and downs
- Economic depressions (the Great Depression)
- Financial crises
- Causes and effects of crises
- Managing crises

For referens: ”the Ideal economy” 101 Economics perspective

- GDP-growth 3-4 % per år
- Inflation 2 % per year (over a 2-year cycle)
- Unemployment around 5-6 %
- Public debt less than 60 % of GDP
- Gov. budget balance, +/- 2 %
- Stabile, but flexible, exchange rate (against major currencies)
- Balance of payment, (maybe a bit more export..)

For referens: ”the Ideal economy” 101 Economics perspective

- GDP-growth 3-4 % per år
  - SWE: 3%
- Inflation 2 % per year (over a 2-year cycle)
  - SWE: 1,9%
- Unemployment around 5-6 %
  - SWE: 6,6%
- Public debt less than 60 % of GDP
  - SWE: 40%
- Gov. budget balance, +/- 2 %
  - SWE: +/-0%
- Stabile, but flexible, exchange rate (against major currencies)
  - SWE: ⬇
- Balance of payment, (maybe a bit more export..)
  - SWE: +

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Also ideal: Financial stability

- Post-global crisis policy area
  - Few had ”big picture”-perspective on financial system
  - Few understood scale and impact of interconnectedness
  - Lots of trust in market’s risk management techniques

- But hard to define
  - ”the absence of excessive volatility, stress or crises” Gadanecz & Jayaram (2015)

- Macroprudential regulation and supervision
  - Stress tests of banks
  - Extra-monitoring of ”Too big to Fail”-banks
  - More regulation and supervision

- OBS – stability objective in conflict with market competition objective

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Economic ups and downs

- The ”business” cycle
- Economic Recessions
- Economic Depressions (the Great…)
- Fiscal and monetary policy to handle ups and downs

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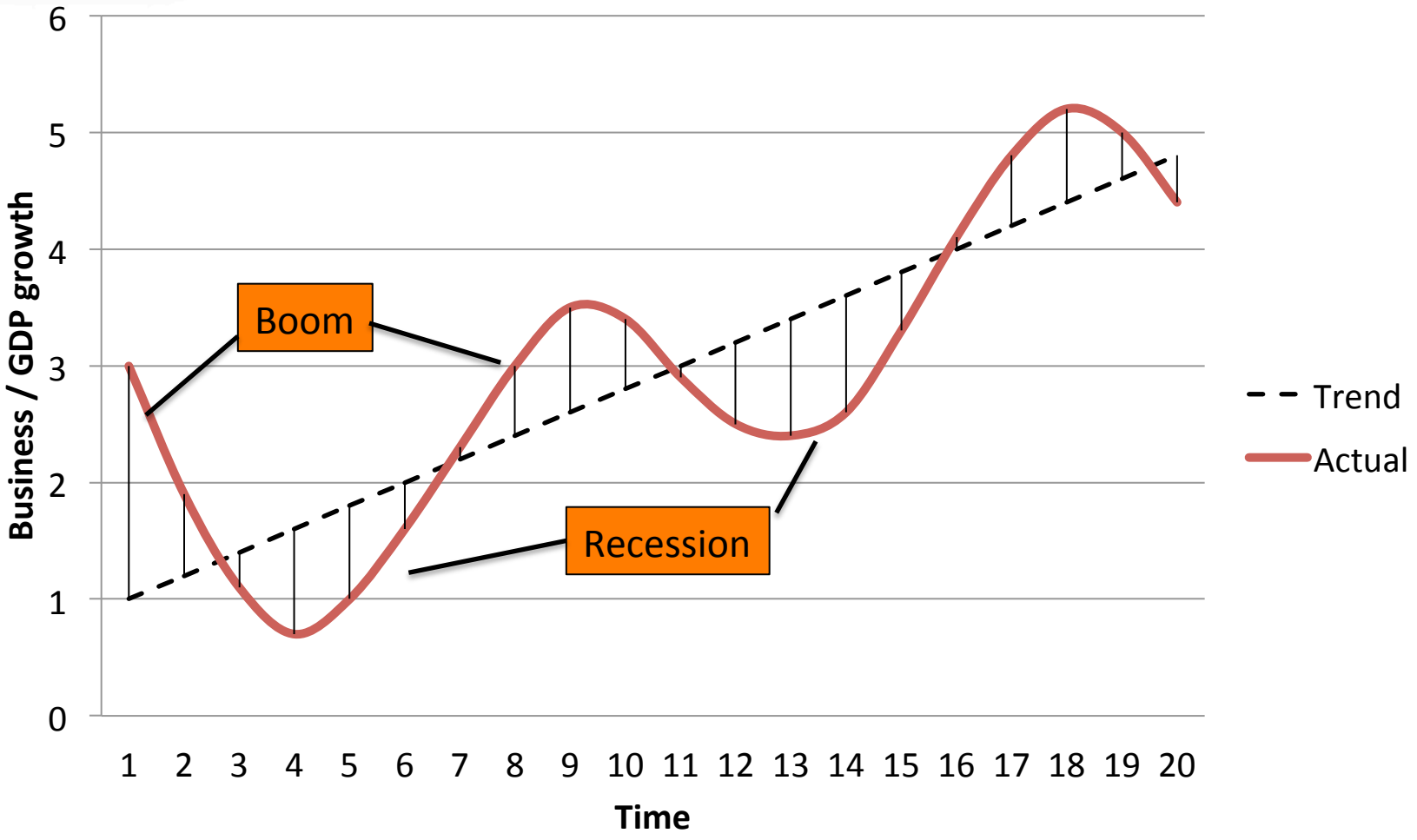
Economic booms and recessions



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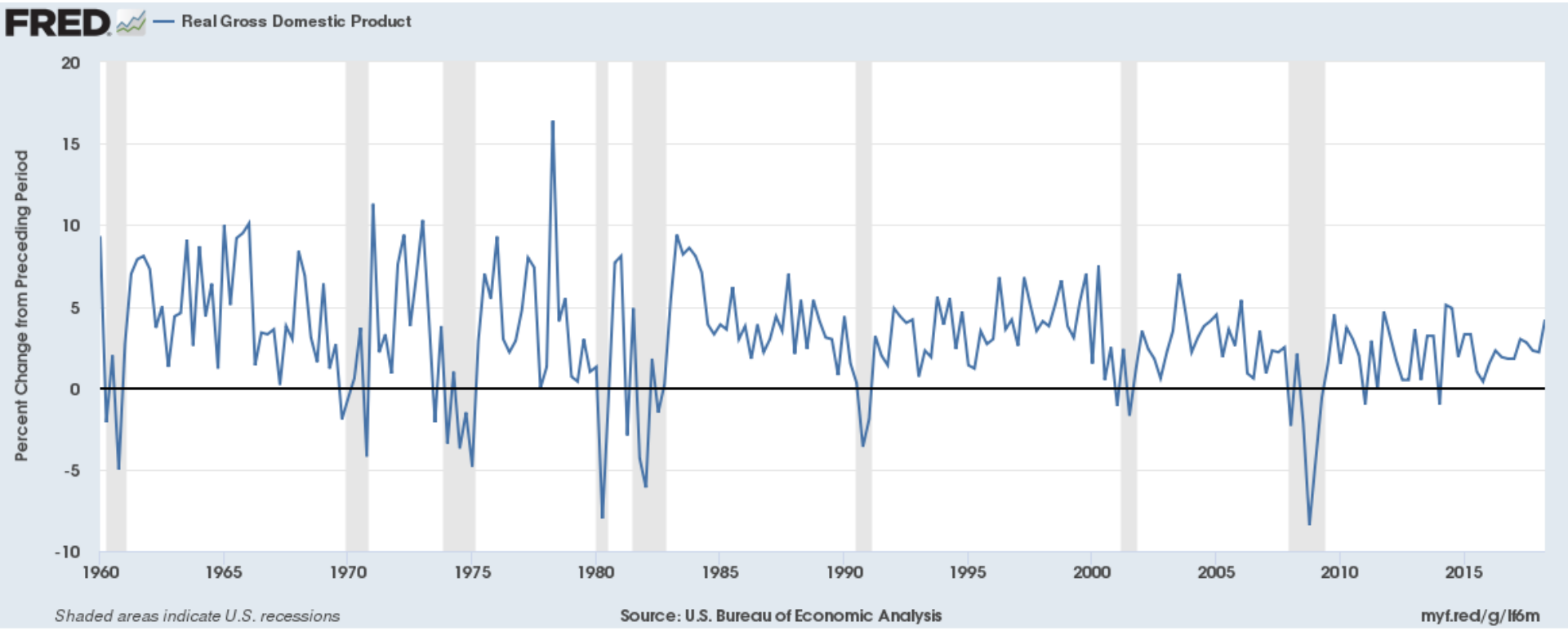
Booms and recessions in the US, 1960-2018



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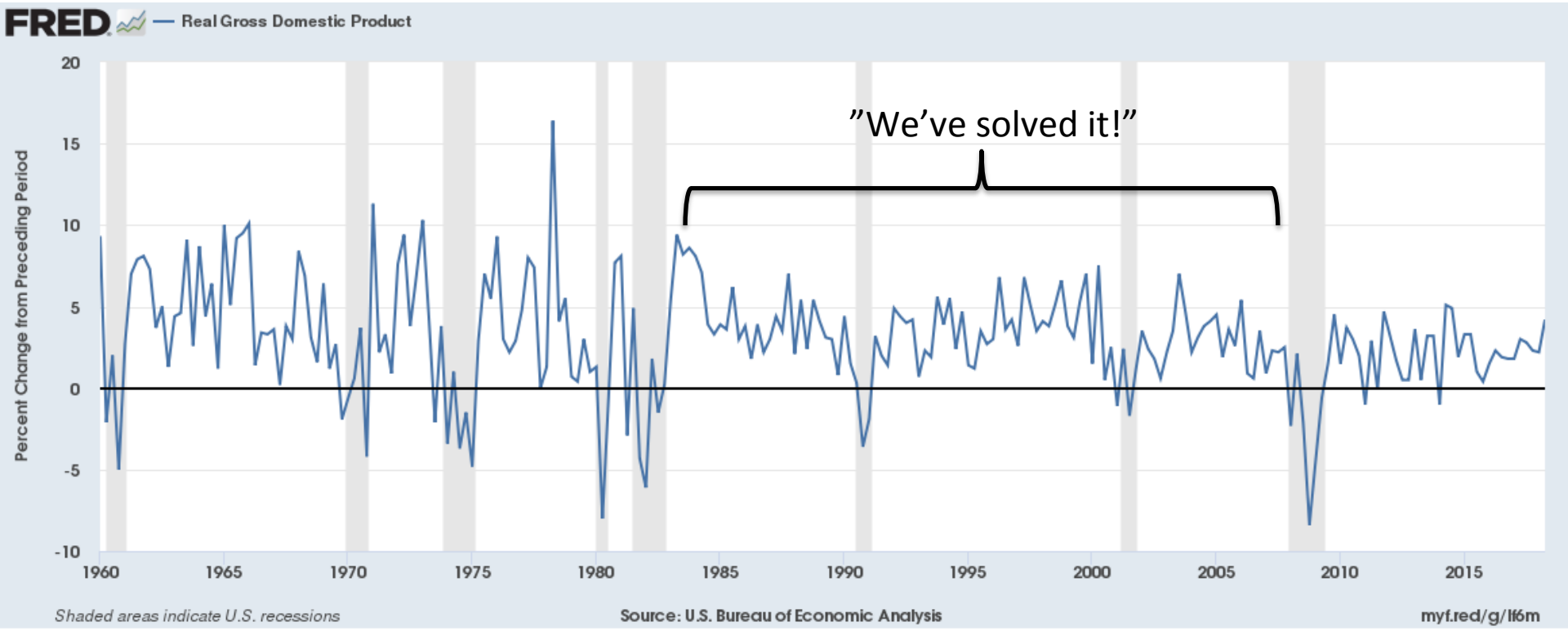
Booms and recessions in the US, 1960-2018



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Dealing with ups and downs

- Fiscal policy and regulation
  - Balance or underbalance the budget? (austerity vs stimilation)
  - Taxes, subsidies, welfare transfers
  - Industry support
  - Trade barriers
  - Private / public ownership
  - Welfare system
  - ”Bail-ins” to financial companies / markets in distress

- Monetary policy
  - Interest rate
  - Money supply
  - Exchange rate
  - Lending to banks - Lender of Last Resort
  - Buy assets from banks – Quantitative easing

- Financial regulation and supervision
  - Charter requirements
  - Capital and liquidity requirements for banks
  - Constrain permitted businesses
  - Deposit guarantees
  - Continuous moniting of conduct and risk taking - supervision

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Economic depressions

- ”The Great Depression” 1920s and 1930s more or less
- Worldwide
- LOOONG economic recession = depression
- Financial crisis just the trigger – strucural problems revealed
- Traumantic and significant
  - for politics and economic policy
  - for economics discipline
  - for ideas about how ”not” to do in a financial/ economic crisis
  - the financial system revealed as ”systemic”

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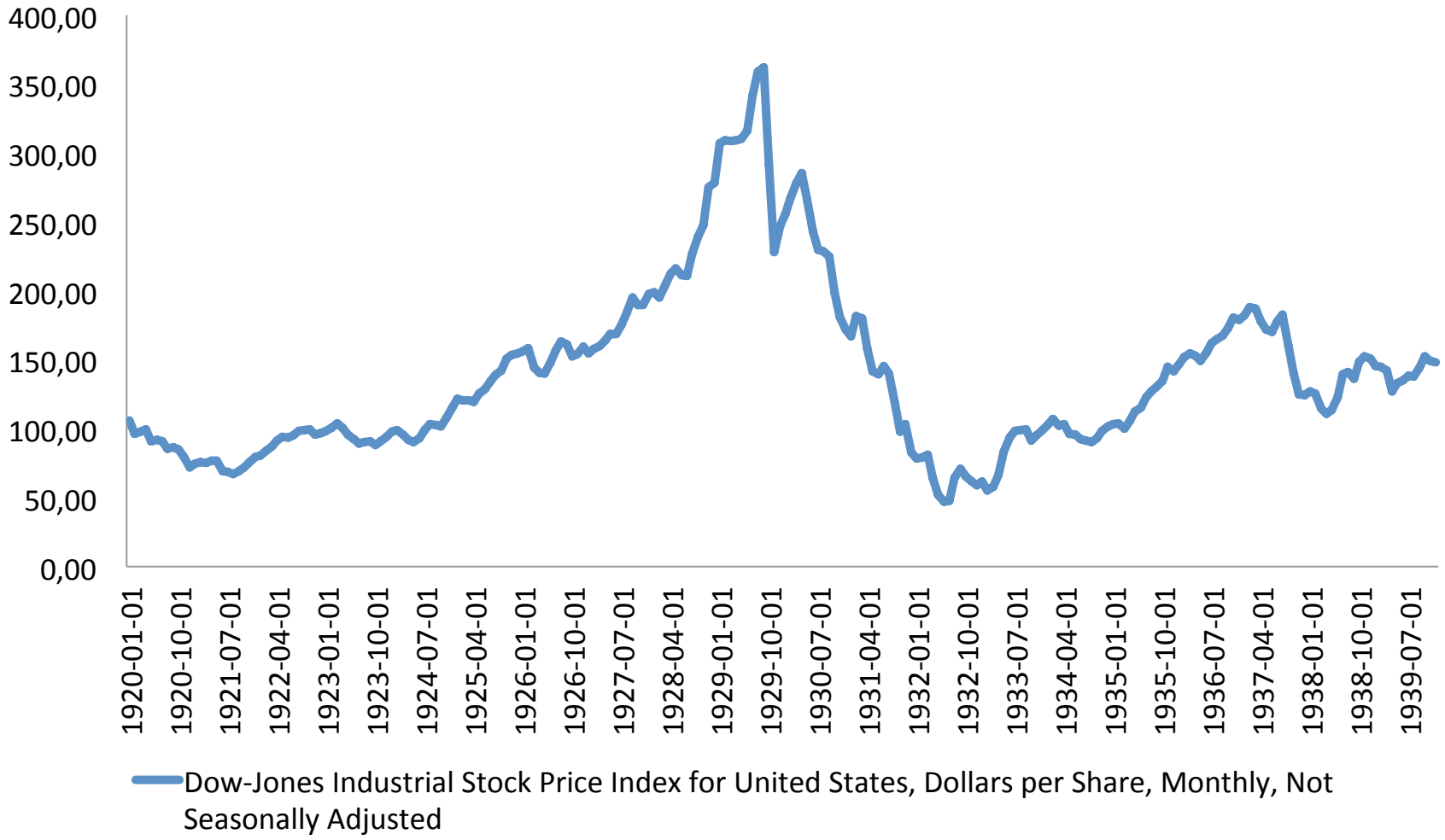
US Stock market boom and bust, 1920-1939



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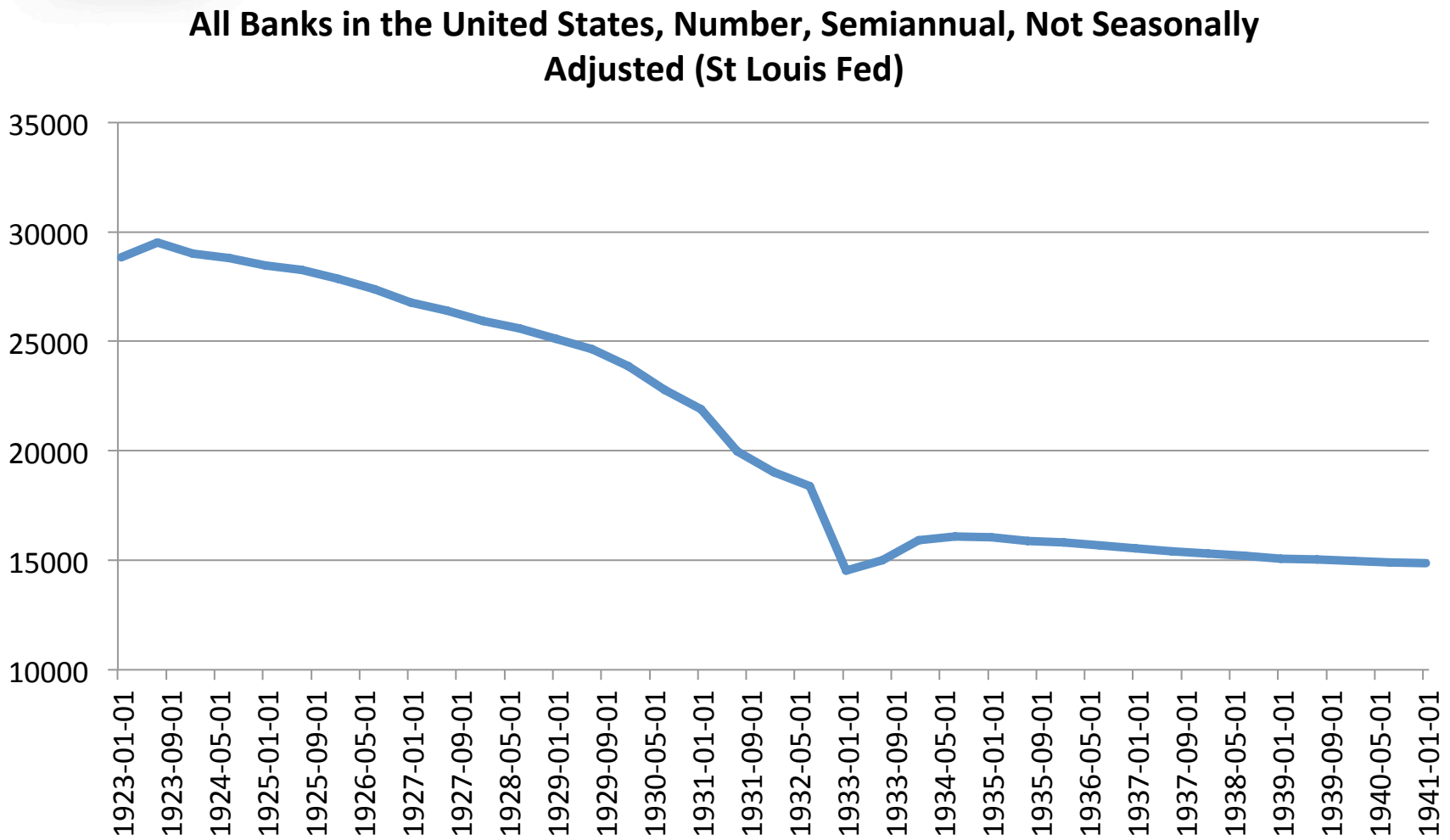
Some 10 000 bank failures



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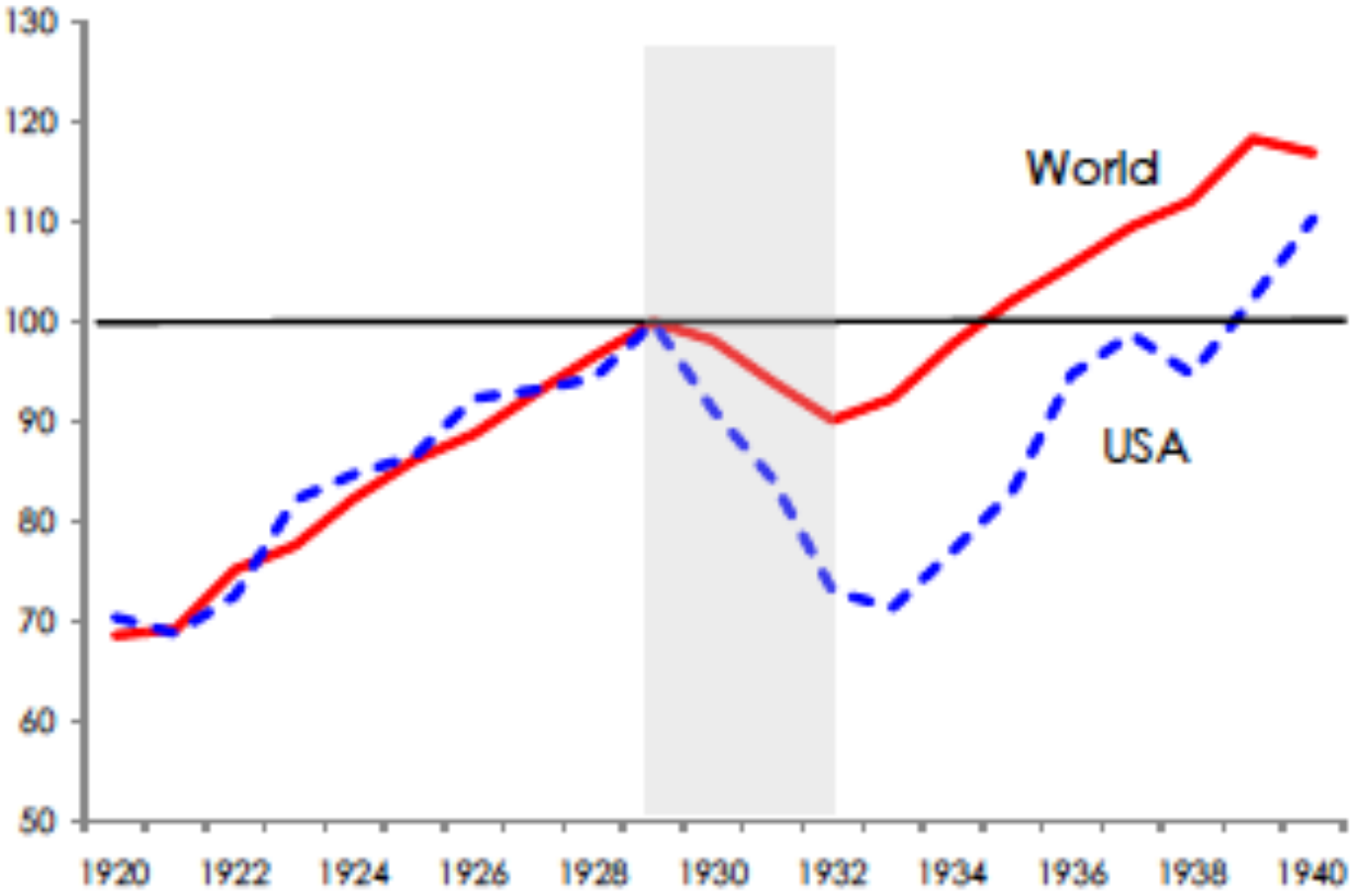
US GDP Growth (1929=100)



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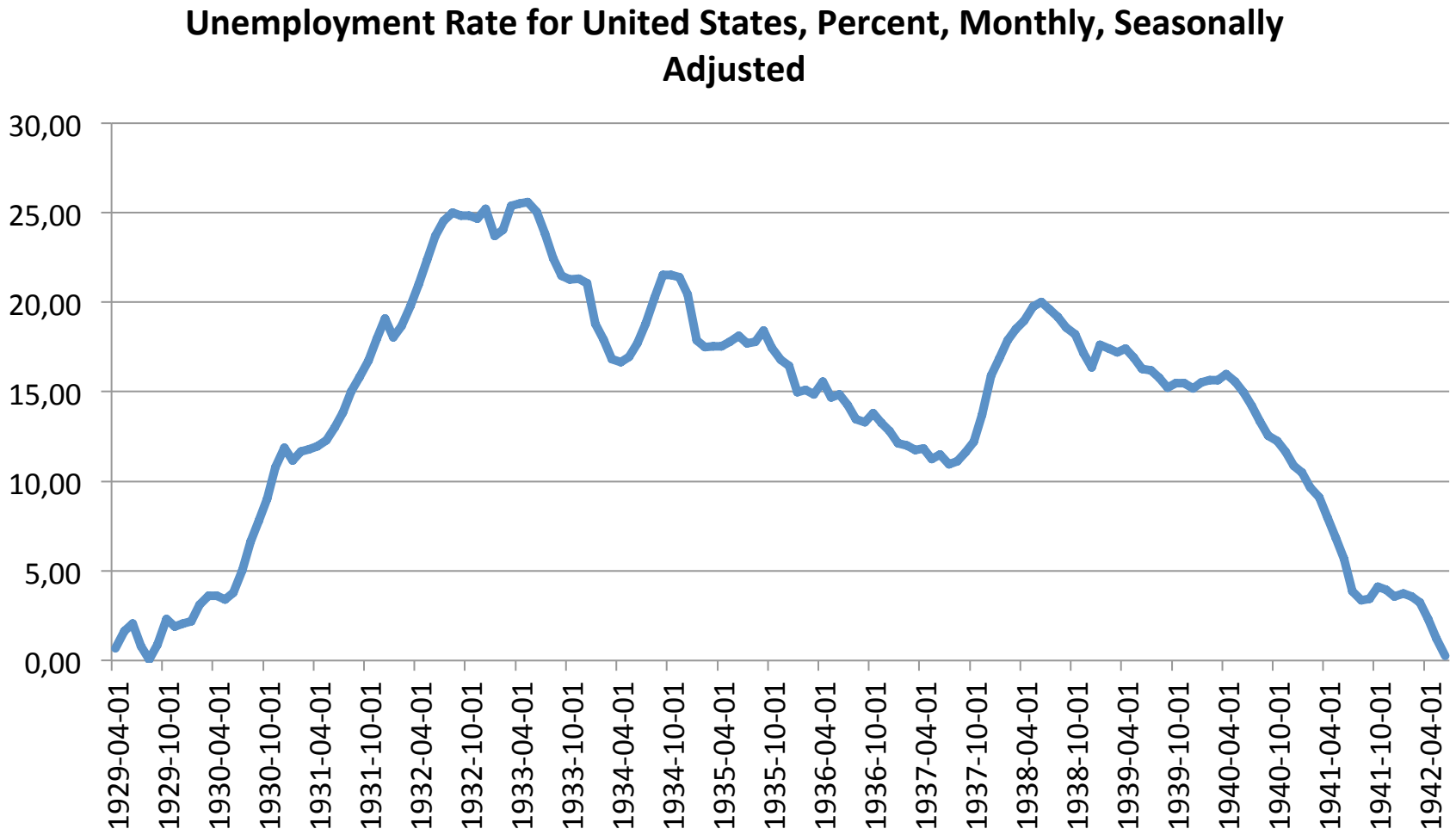
US Unemploymnet 1929-42



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Crisis managment during US Great Depression

- **Fiscal policy and regulation**
  - Balance or underbalance the budget? (**austerity** vs stimilation)
  - Taxes, subsidies, welfare transfers
  - Industry support
  - **Trade barriers**
  - Private / public ownership
  - **Welfare system**
  - ”Bail-ins” to financial companies / markets in distress

- **Monetary policy**
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- **Financial regulation and supervision**
  - **Charter requirements**
  - **Capital and liquidity requirements for banks**
  - **Constrain permitted businesses**
  - **Deposit guarantees**
  - **Continuous moniting of conduct and risk taking - supervision**

OBS – Lessons from Great Depression influenced crisis responce 2007-2009

- Everything went wrong in management of Great Depression

- Especially – monetary policy was stupid

	1929-1939	2007-2007
Lower interest rates	NO	YES
Lend to banks	NO	YES
Let banks fail	YES	NO*

* Except Lehman brothers – but an investment bank

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Financial crises

- Types of financial crises
- Causes
- Effects

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Financial crises

- Different types and combinations
  - **Inflation crises**
  - Currency crashes and debasement
  - **Banking crises**
  - **Public debt crisis**
  - **deflation crises**
  - Stock market crashes
- Main problems
  - Problems in ”real economy”
  - Problem if financial ”infrastructure” malfunction

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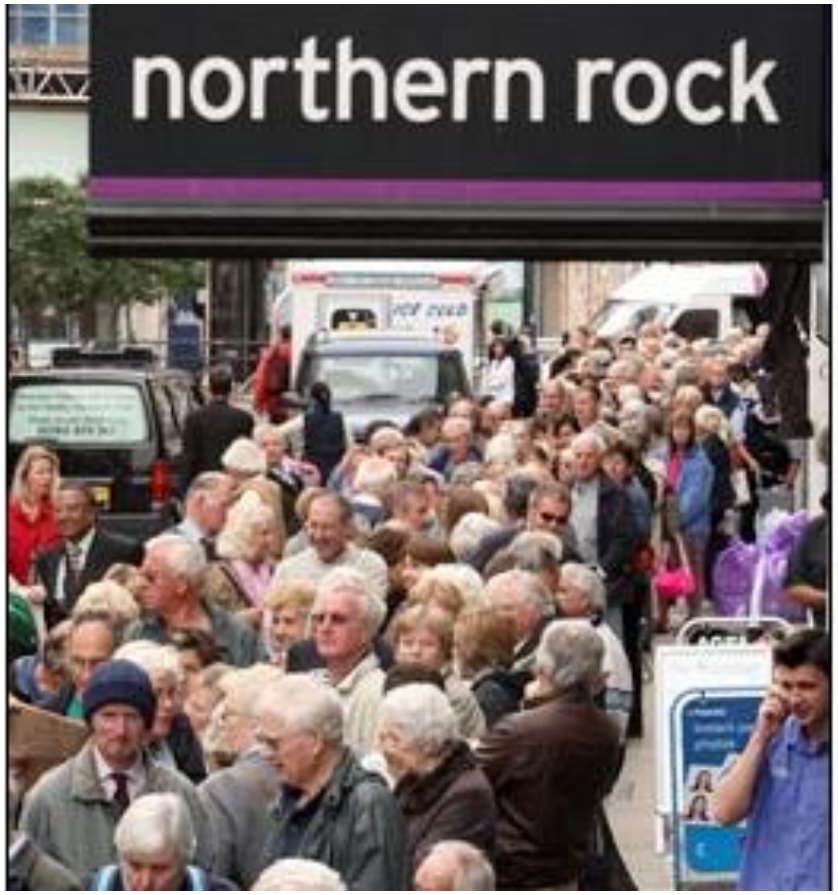
Banking crises

- Historically quite frequent
- Occurs in all countries
- Problematic due to link to real economy
  - services
  - infrastructure
- Rule of thumb is to **rescue illiquid but solvent banks**
- Problems due to lack of info, ”too-big-to-fail”, ”capture”

Bank runs and their systemic contagion

- Banks only hold fraction of deposits ready for direct withdraw
- If too many depositors withdraw simultaneoulsy, bank is forced to s any price…
- Run + “fire sale” of assets spread banks



- Policy responses
  - Lender of last Resort
  - Deposit guarantee
  - Bank to hold buffers – liquidity & capital

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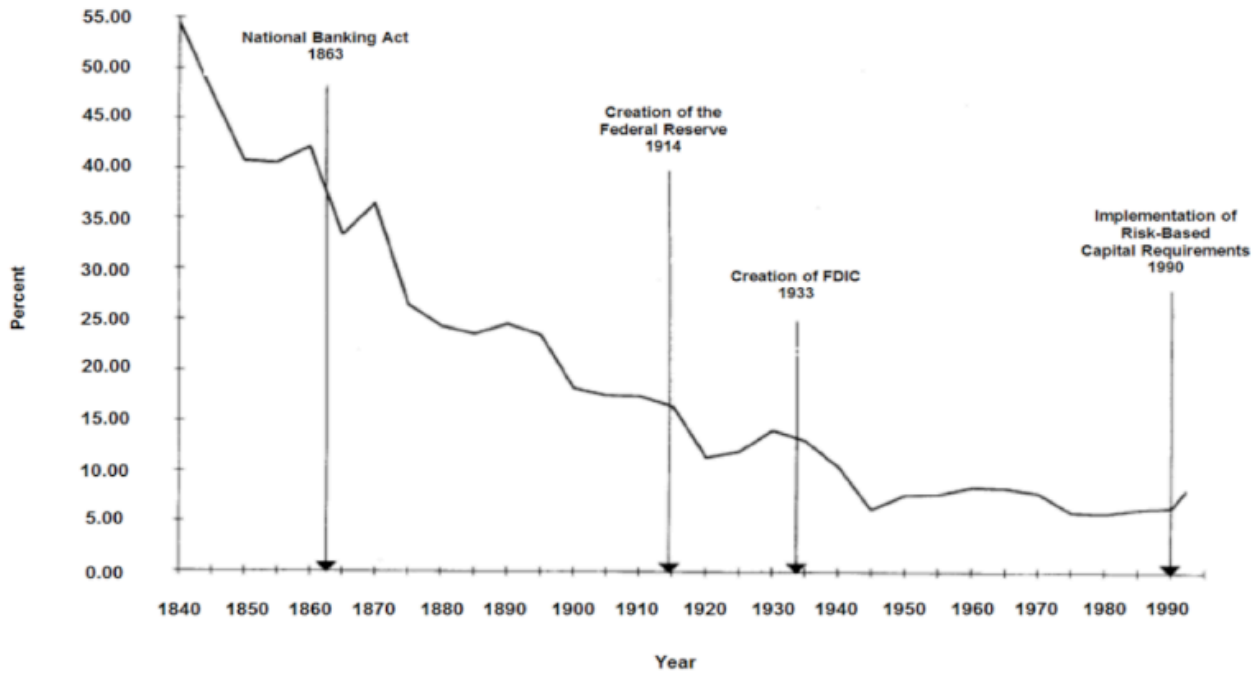
Bank capital / equity – the Bank's buffer

Chart 5: Equity as a Percent of Assets for U.S. Commercial Banks from 1840 to 1993

Ratio of Aggregate Dollar Value of Bank Book Equity to Aggregate Dollar Value of Bank Book Assets



Source: Statistical Abstracts through 1970, Report of Condition and Income thereafter. From Table 5 in: Berger, A., Herring, R. and G. Szegő , 1995, "The role of capital in financial institutions," Journal of Banking and Finance 19, 393-430.

https://www.fdic.gov/news/news/speeches/spapr0913.html#chart5

Inflation and deflation crises

- Reinhart & Rogoff definition (2009): Inflation higher than 20% over one year

- Problems with inflation:

  - Savings and wages lose purchasing power
  - Loans lose in ”real” value – so banks reluctant to lend
  - Driven by expectations about more inflation to come, tendency for self-enforcing

- Deflation crisis – the opposite
  - Prices goes down, purchasing power goes up
  - Makes sense to wait with purchase – slows down economy

Worst case: Hyperinflation

- Zimbabwe
- Germany during and after WW1:

1914	1923
1 $US = 4,2 Mark	1 $US = 4,2 trillion Mark

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Sovereign debt default:

- A country stops paying on its loans / do not repay loans
- In practice a default triggers negotiations on:

  - what **interest rate** to pay

  - **how much** to repay

  - **when** payments are due

  - In what **currency**

  - **Whom** to pay

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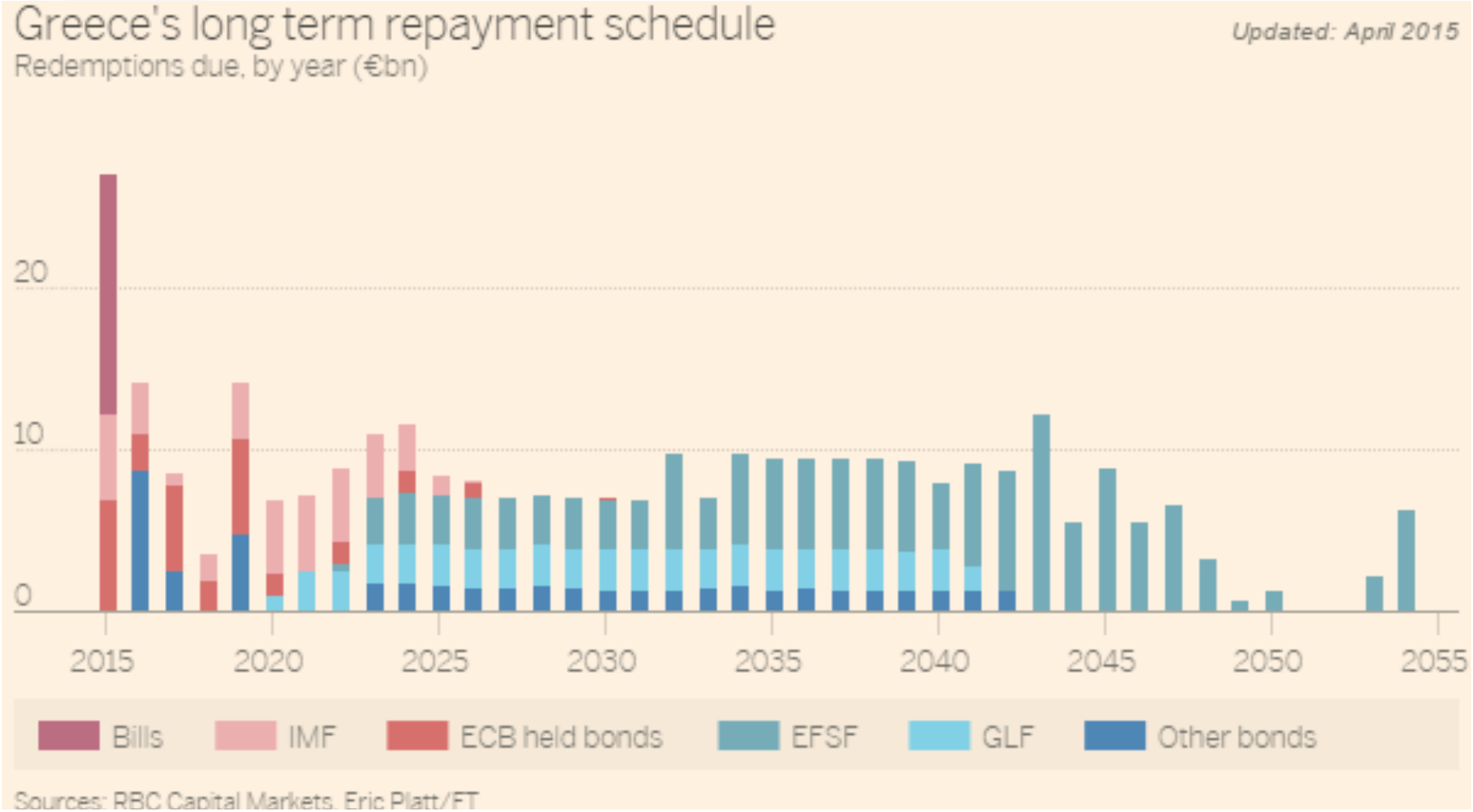
Greek sovereign debt and repayment



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Causes

- Financial globalisation itself?
- Cost and ease of borrowing
- Self-enforcing momentum via booming asset markets (housing, securities etc.)
- ”Experts” (Galbraight) saying ”This time is different” (Reinhart & Rogoff) because ”we’ve solved it” (Lucas)
- Incompetence, greed etc.
- Institutional failures – e.g. Missing macroprudential outlook

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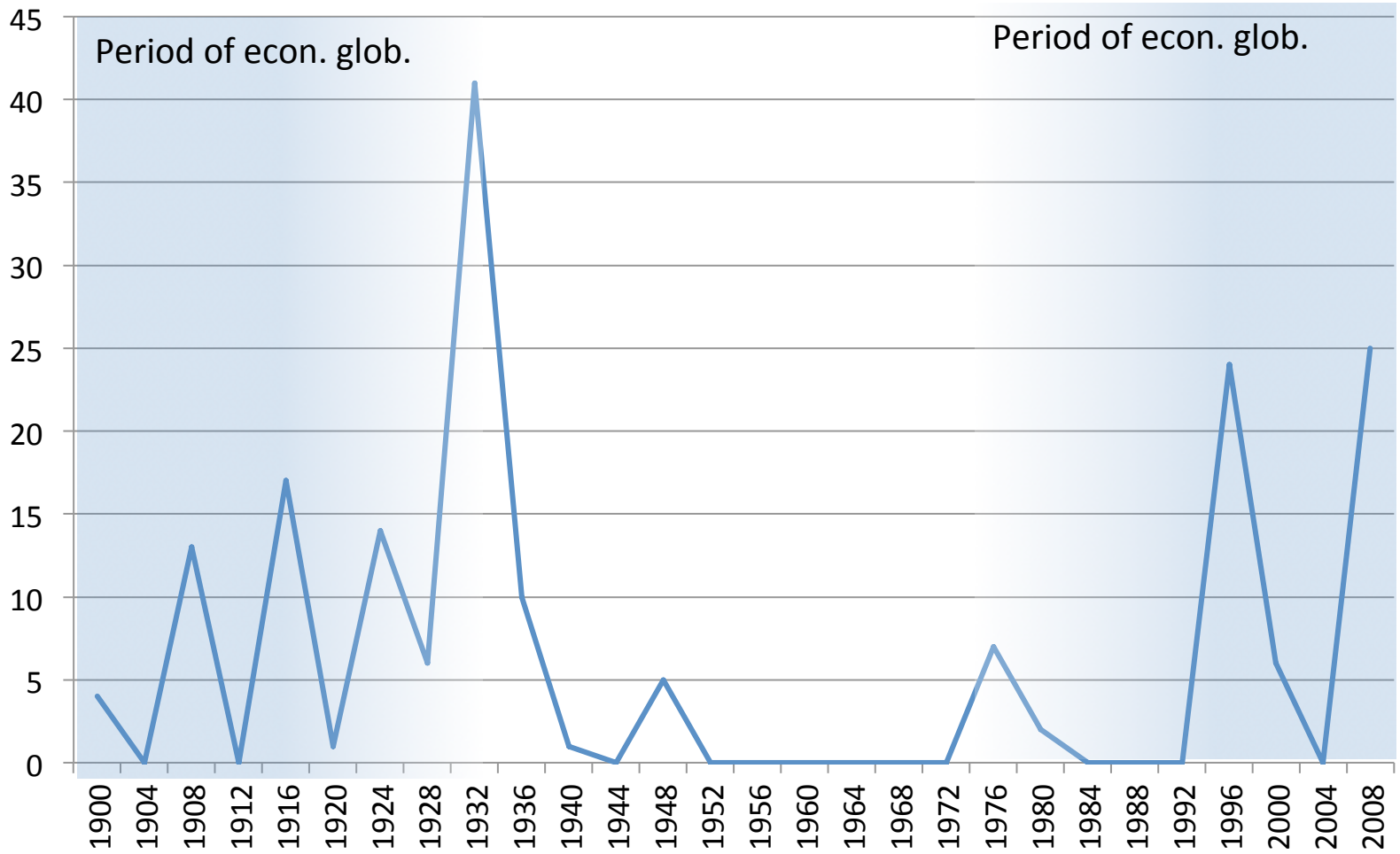
Share of countries with systemic banking crisis, by share of world economy



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Effects of financial crises

- Recession (GDP growth weak or even negative
- Bankruptcies
- Unemploymnet
- More financial crises…
- Weaker public finances

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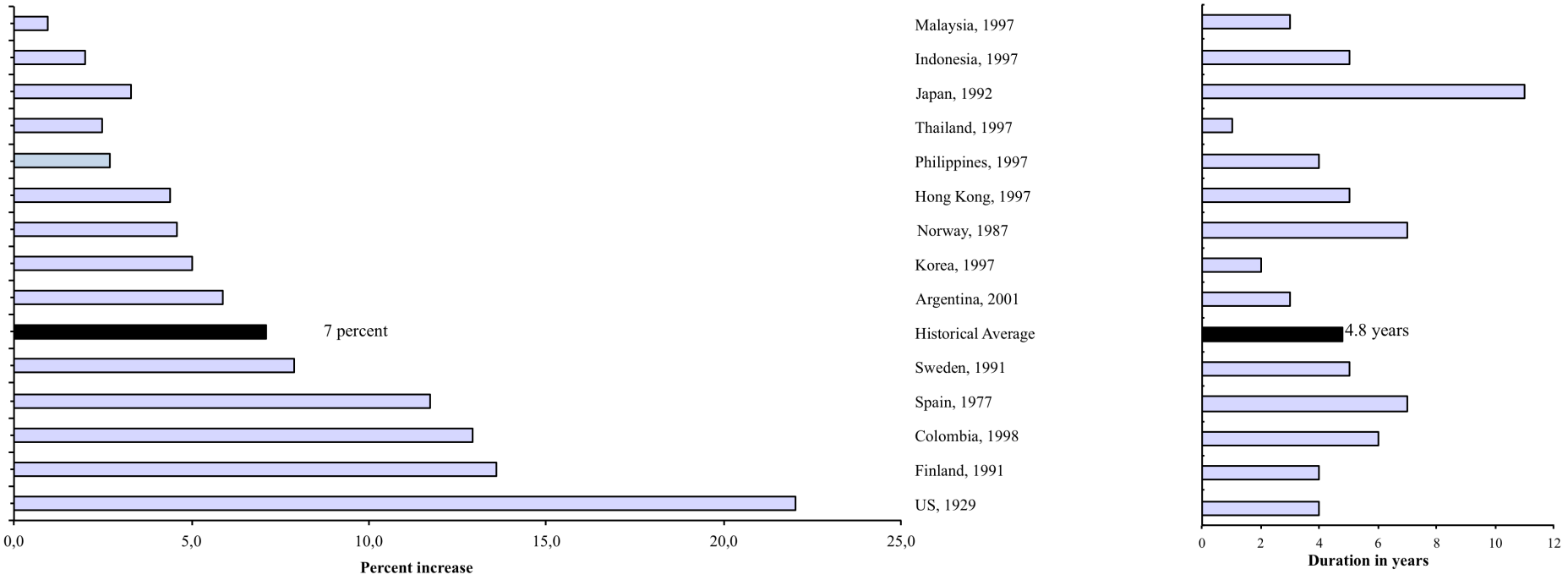
Unemployment after a bank crisis

14.3 Cycles of past unemployment and banking crises
Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



Sources: OECD, IMF, Historical Statistics of the United States (HSOUS), various country sources, and authors' calculations.
Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes.

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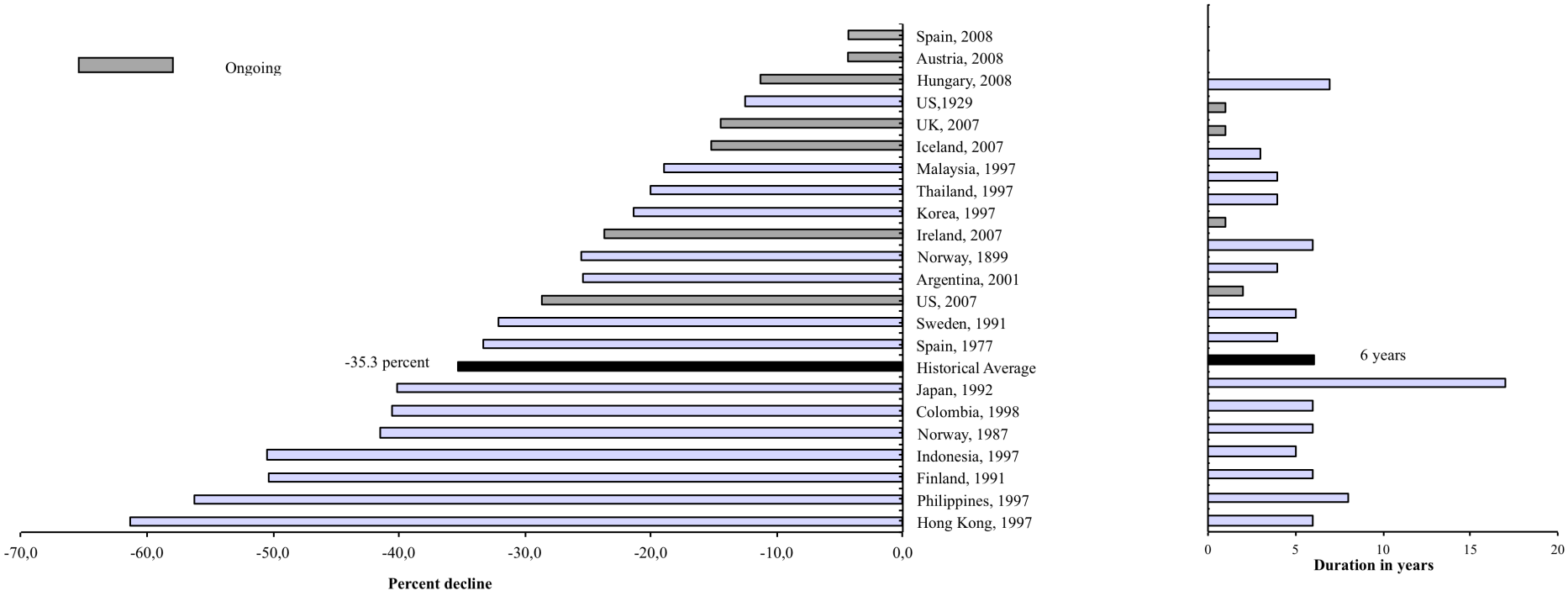
Real estate prices after systemic bank crisis

14.1 Cycles of past and ongoing real house prices and banking crises
Peak-to-trough price declines (left panel) and years duration of downturn (right panel)



Sources: Reinhart and Rogoff (2008b) and sources cited therein.
Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. For the ongoing episodes, the calculations are based on data through the following periods: October 2008, monthly, for Iceland and Ireland; 2007, annual, for Hungary; and 2008:Q3, quarterly, for all others. Consumer price indices are used to deflate nominal house prices.

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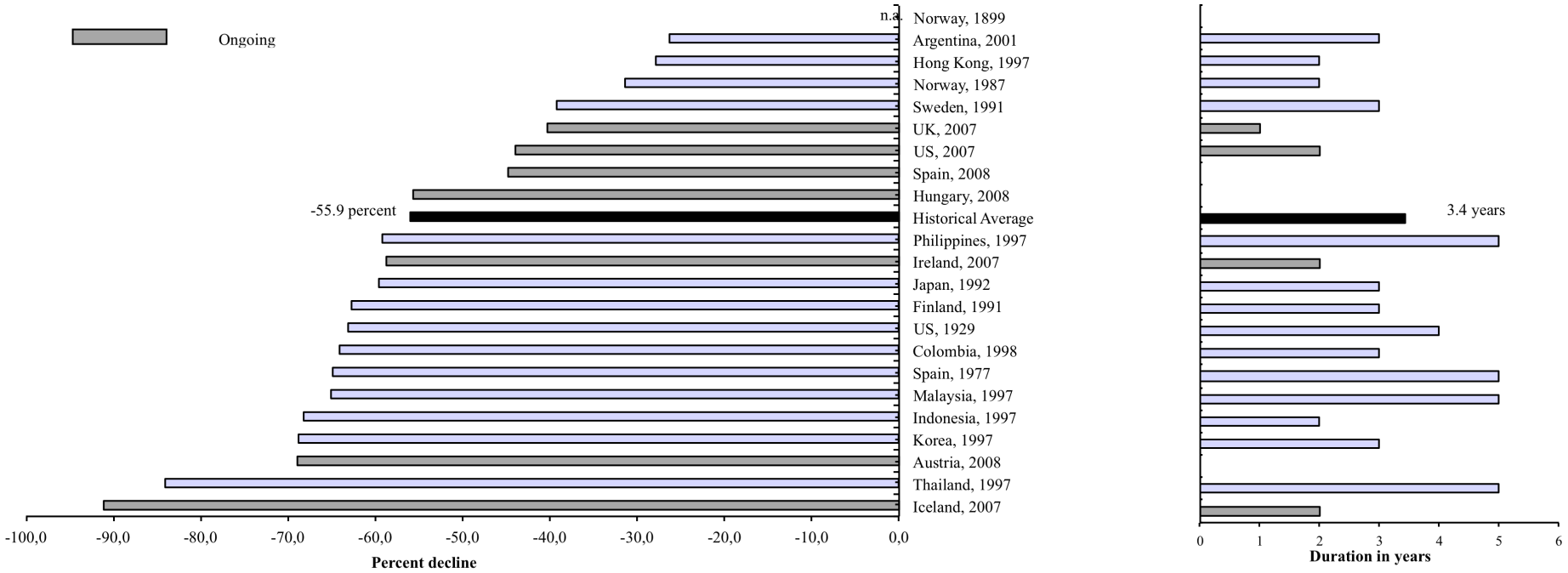
Stock markets after banking crises

14.2 Cycles of past and ongoing real equity prices and banking crises
Peak-to-trough price declines (left panel) and years duration of downturn (right panel)



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Other effects

- Financial / economic stress
  - depressions
  - domestic abuse
  - birth weights
- Political sentiment
  - more extreme to right and left
  - elite resentment
- Economic policy shifts
  - Immediate symptoms treated
  - Longer term problems down-prioritised
  - Highly politicized (austerity vs. stimulation)

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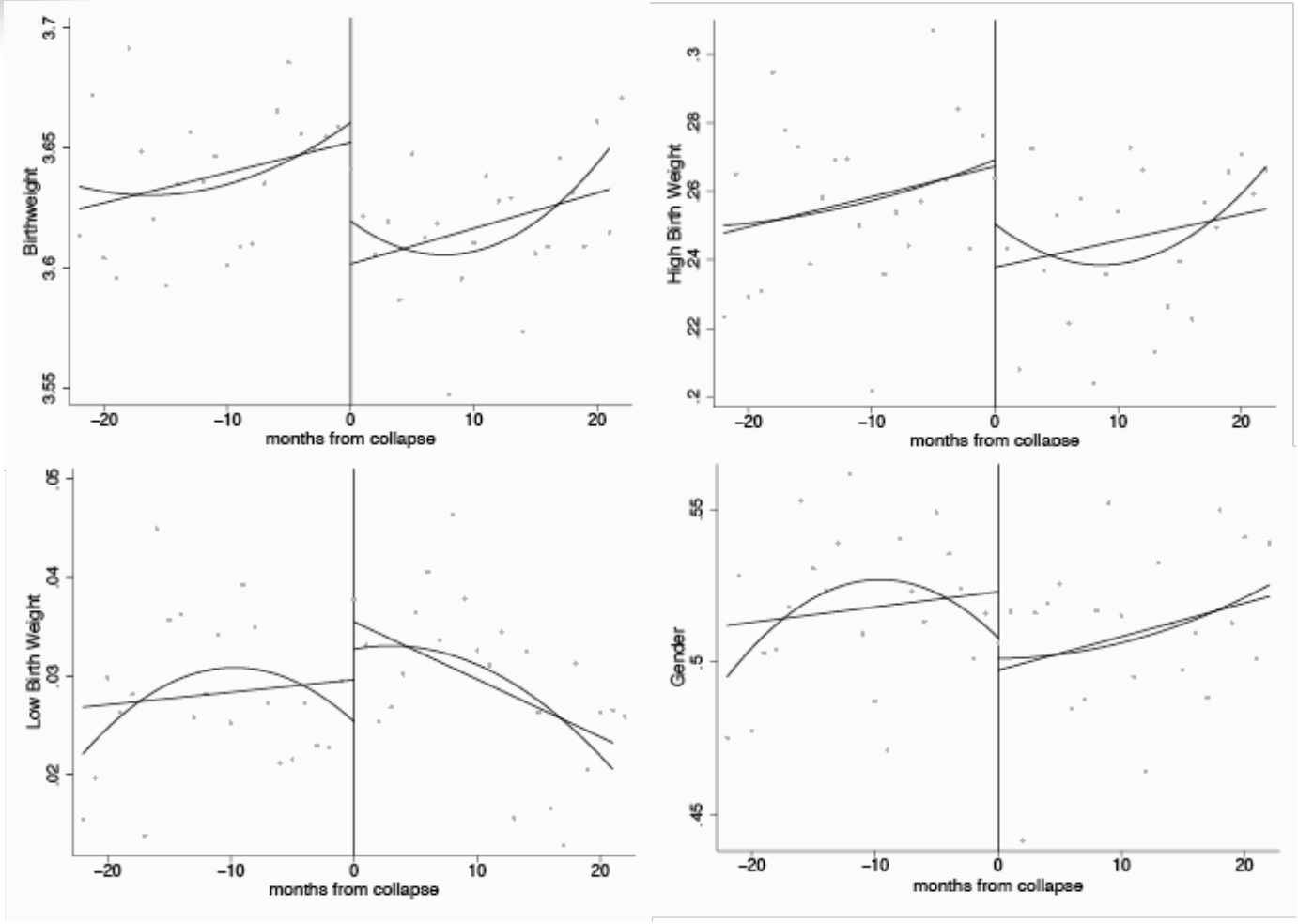
Financial stress (Vardandottir, 2016)



Birth outcomes around the time of the collapse (Financial crisis in Iceland)

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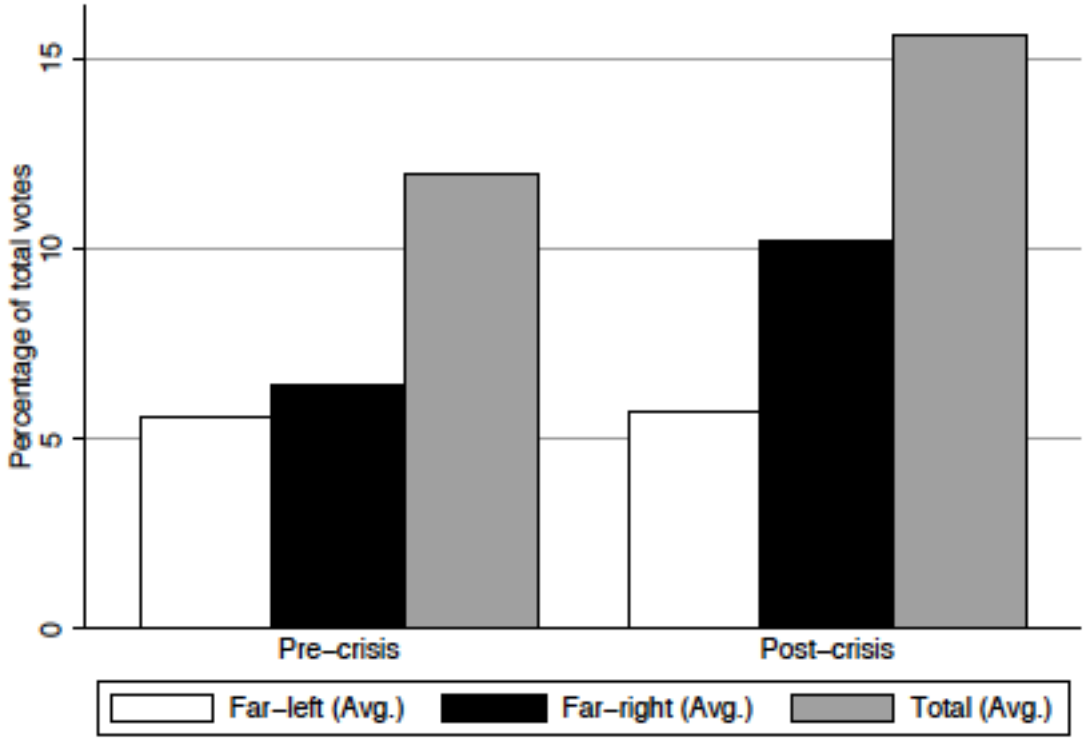
Financial crises effects on political sentiments (1870-2015)

Figure 1: Vote shares of the far right and left



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Economic policy priorities shift

- Real economy effects:
  - Unemployment
  - Bankruptcies
    - Less tax revenue
    - more welfare expenditures
      - weaker government finances
        - downsize budget to balance
        - increase debt
        - forced to prioritize
          - welfare tranfers
          - culture & society
          - environment investments
          - foreign aid
            - resentment of elite..