

CSI: credit crunch

The Economist

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subprime crisis

- is also a banking crisis
- a crisis of liquidity
- a crisis of collateral
- most of all, a crisis of central banking

home prices

Between 1997 and 2006

- American home-price index rose by 124%
- Britain: 194%
- Spain: 180%
- Ireland: 253%

America's case

- What was peculiar to America: large numbers of subprime borrowers—those with poor credit records
- By 2006 a fifth of all new mortgages were subprime
- Lower “teaser” rates were charged for a while before higher, market-based rates kicked in

Securitization

- Financial assets had been turned into securities that could be bought and sold
- Lenders (banks) could sell bundles of them to other banks and investment funds at home or abroad
- securitization reduced their incentives to look carefully at their borrowers

Crisis: August 9th 2007

- Overnight interbank rates in the euro zone spiked to 4.6% on August 8th [was 4.0%]
- The next day, ECB injecting US\$131 billion into the money market
- Fed did the same later

The moment of truth

- The rot started when the teaser rate ran out and the American housing market slowed
- Two **hedge funds** run by Bear Stearns were found to have suffered huge losses on subprime
- More bad news made such securities increasingly hard to value and harder still to borrow against or sell

Liquidity crisis

- In August the banks deserted each other
- Banks were reluctant to lend to each other because they did not know whether the other banks might be in troubles
- They also feared that they might have to rescue their own troubled conduits

Liquidity crisis

- One job of the central banks is to keep the financial system working smoothly by ensuring that the banking system has enough liquidity
- However, if a central bank pumps in liquidity too eagerly, it may create **moral hazard**

stabilization

- The other job: macroeconomic stabilization—setting interest rates to keep inflation in check without causing the economy to stop and start
- However, if a central bank responds by cutting official interest rates too drastically, it may push up inflation
- Dual dilemmas: liquidity crisis and medium-term goal of price stabilization