Credit Market Turmoil of 2007–08: Implications for Public Policy

How Serious is the Damage?

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Preview

- Not all bubbles are created equal
- Factors underpinning bubble and its resolution influence extent of
  - financial crisis
  - amplification of business cycle

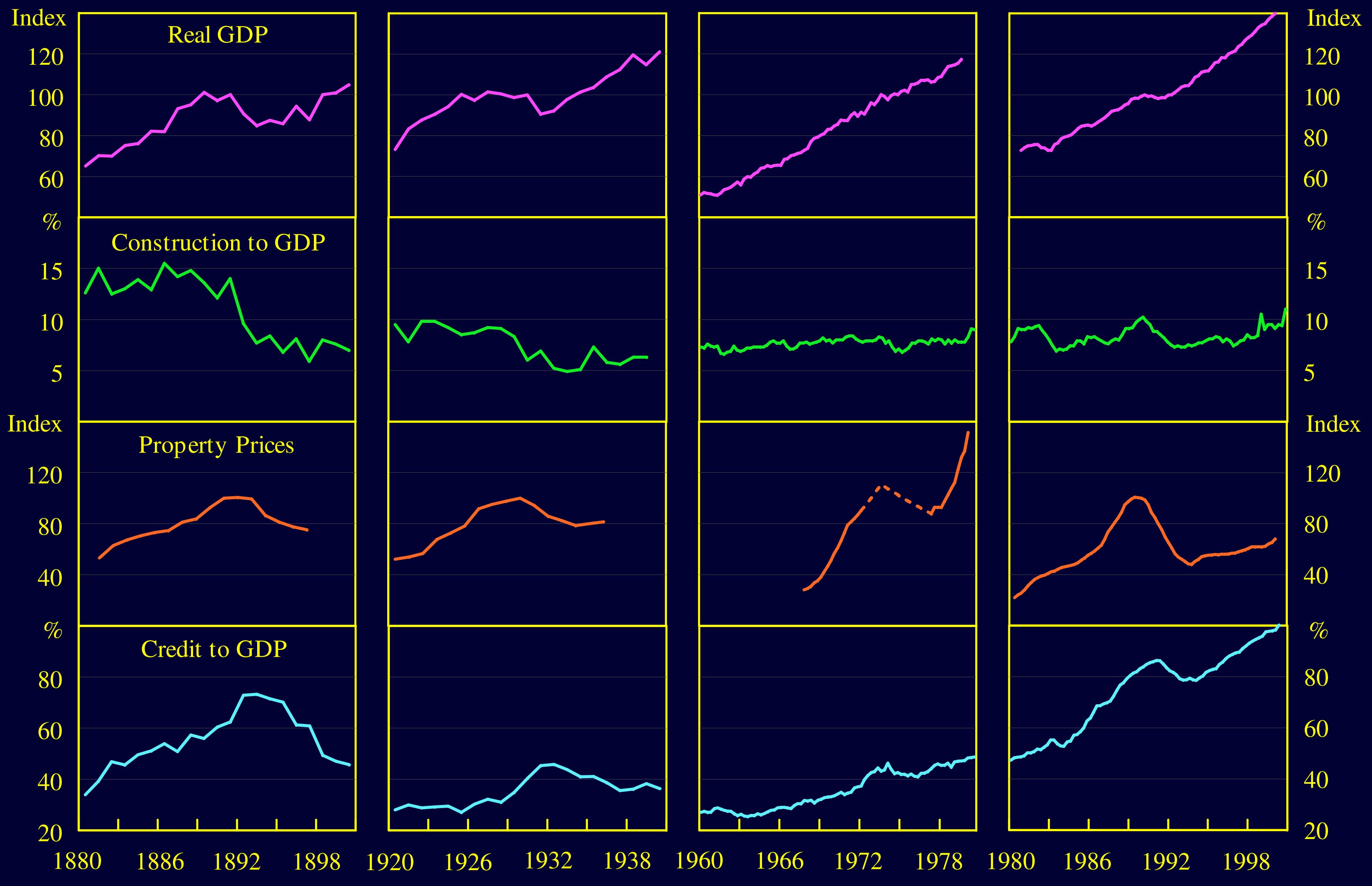
Australian Experience

Four episodes – cycles in credit/property

1890s 1930s 1970s 1990s

D'Arcy and Kent (2000), 'Cyclical Prudence – Credit Cycles in Australia'
Fisher and Kent (2000), 'Two Depressions, One Banking Collapse'
Kent and Lowe (1998), 'Property-Price Cycles and Monetary Policy'

Cycles in Australian Output, Construction, Property Prices and Credit

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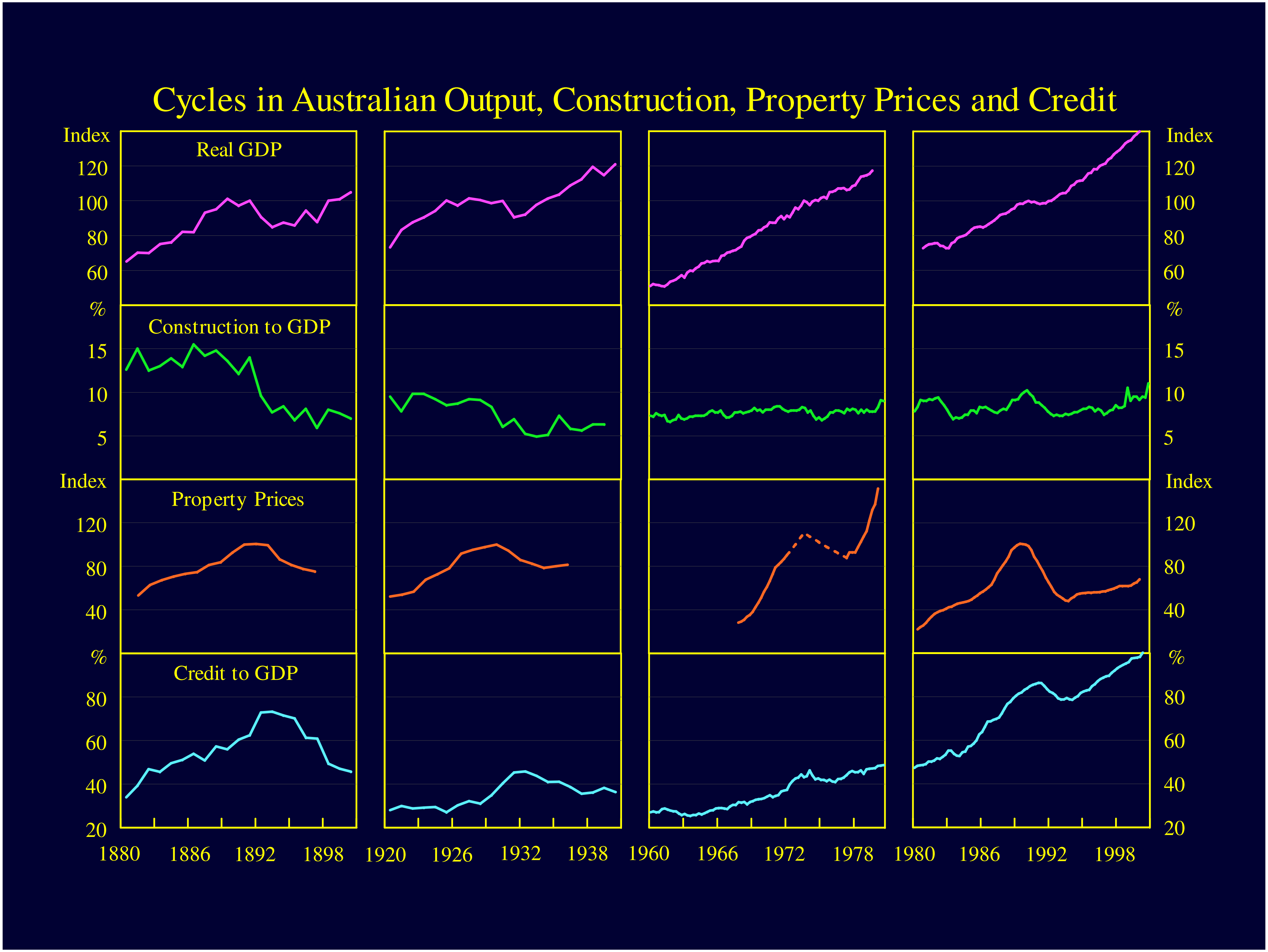
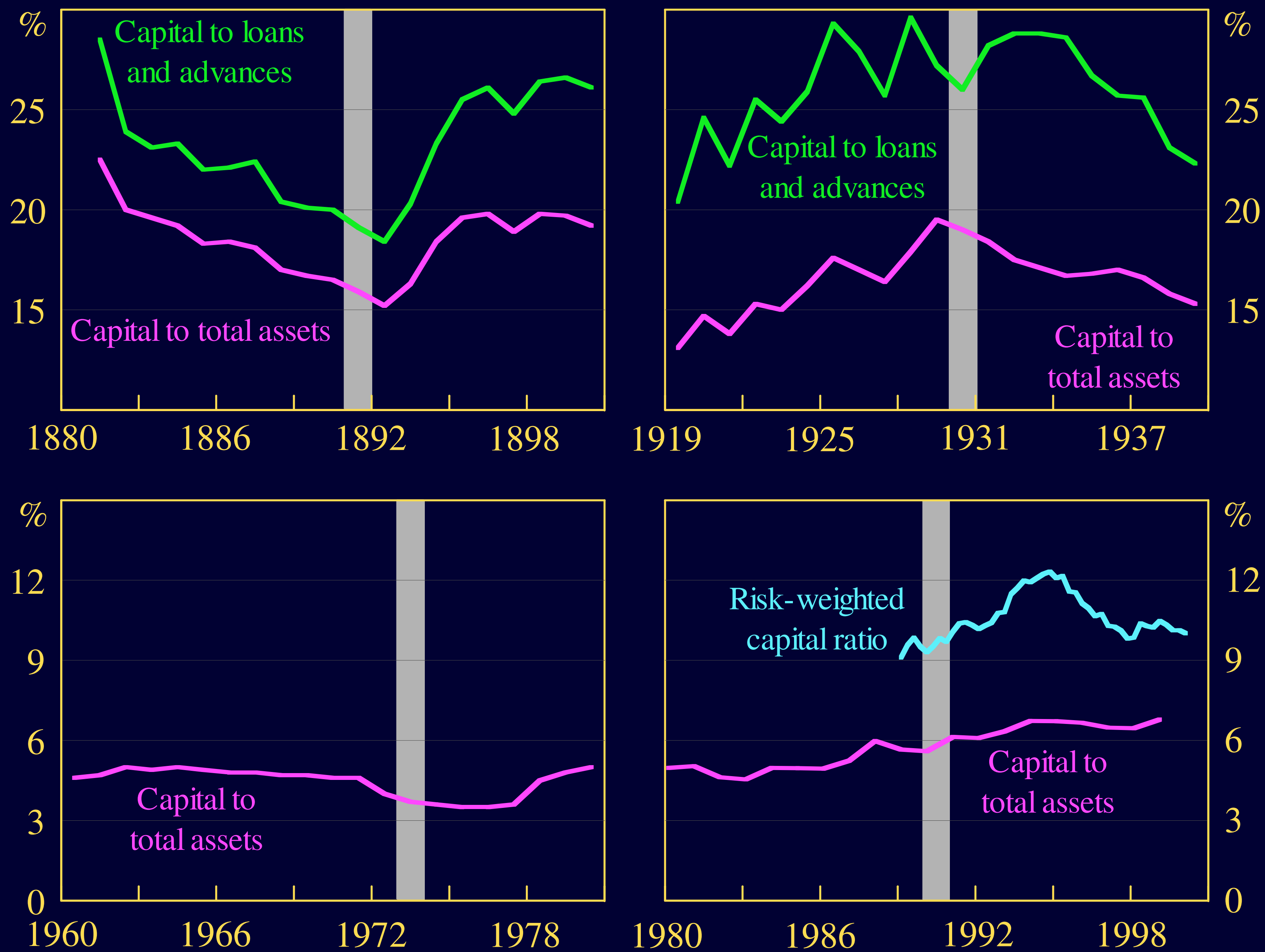

Cycles in Australian Output, Construction, Property Prices and Credit
Index
Real GDP
120
100
80
60
%
Construction to GDP
15
10
5
Index
Property Prices
120
80
40
%
Credit to GDP
80
60
40
20
1880
1886
1892
1898
1920
1926
1932
1938
1960
1966
1972
1978
1980
1986
1992
1998

Capital Ratios



Note: Shading indicates peaks in real GDP.

Factors underpinning costly Australian crises

i. *credit* growth above trend PLUS

ii. rapid inflation *collateral* prices

iii. excessive *concentration* of investment/lending

iv. lack of *capital* accumulation

v. *competitive* pressures – liberalisation/innovation

- i. and ii. – Borio and Lowe (2002) – speed kills
- during contractions – policy matters

Patrick Honohan – Bank Failures

What he says…

- Overconfidence in risk management models
- Detailed account of a number of ‘failing’ financial institutions
- Estimates direct costs of write-downs and fiscal support
- Policy?
  - Short-term response to failing institutions – slow, equity losers, managers?
  - Long-term – need less rules based, more discretionary approaches to risk management

Patrick Honohan – Bank Failures

What I thought…

- The problem with models
  - ‘Normal’ times vs tail events?
  - Perceived risk – recent realisations – difference from actual risk?
  - Perceptions better than actual in upturns, worse in downturns
  - Models too similar? One-sided markets
- Case studies, common theme?
  - Rapid growth, capacity to manage/control? Driven by concerns re revenues & market-shares – e.g. UBS
- ‘Successful’ institutions’ strategies?
  - Senior Supervisors Group (2008)
- Why is capital so expensive?
  - Overoptimism of creditors – exit, rescue, perceived risks

David Greenlaw – Real Economy Costs

What he does…

- Estimates of losses by leveraged financial institutions
- Assesses implications for domestic lending
  - balance between capital losses and asset reduction
- Examines effect on economic activity
  - single equation estimate GDP growth link to DNFD
  - loan officer survey and TED spreads – used as instruments to identify true supply-side effect

David Greenlaw – Real Economy Costs

What I thought…

- Simplicity of approach is valuable
- But, single equation as it is may miss some important effects
- Financial accelerator – may make things worse
  - recursive feedback from real activity to financial sector: role for collateral prices, longer horizons, asymmetric effects?
- Strong policy response – may make things better
- Need a system of equations

S "Vish" Viswanathan –Financial Market Damage

What he says…

- Review of network market inefficiencies
- Contrast with 'consolidated' markets which have:
  - liquidity under stress, timely & 'accurate' price discovery, standardised products, central clearing house, disclosure rules, resolution of defaults
- Provides description of network market failures
  - amplification of shocks – role of collateral, margins, mark-to-market accounting
- Policy? Regulatory changes needed for
  - More: standardisation, market makers, transparency, role for clearing houses, among other things…

S “Vish” Viswanathan –Financial Market Damage

What I thought…

- Discussion for existence and benefits of network markets
  - why don’t they move to consolidated markets?
  - tailored products likely to remain? But which?
- How to encourage transformation?
  - need to focus on removing impediments to standardisation/simplification, use of clearing houses
- Scope for markets to do much on their own?

Conclusion