Economics 435
The Financial System
Lecture 1
9/2/2015

Instructor: Prof. Menzie Chinn
UW Madison
Fall 2015
Administrative Issues

• Course website:
  http://www.ssc.wisc.edu/~mchinn/web435_fl5.html

• OH: MW4-5, 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 10/19, 11/18
  - Paper due on **T, 12/15**
- **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)

3-Month Libor Minus Overnight Index Swap Spreads
- United States
- Euro Area
- United Kingdom

5-Year Bank Credit Default Swap Spreads
- United States
- Euro Area
- United Kingdom

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 Survey of Professional Forecasters (median)
The “Disappearance” of Risk

Figure 3. Advanced and Emerging Markets: Sovereign and Corporate Bond Spreads, 1998–2008

(In basis points)

Source: IMF, WEO update, 11/6/08
Household debt (I)

Source: BIS, Annual Report (2011)
Household debt (II)

Housing boom (I)

Note: Rescaled to 2001Q4=1.
Source: BIS, Annual Report (2011)
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

GDP, bn. Ch.09$ SAAR

Source: BEA, 2015Q2 2nd release, CBO, Feb, Aug 2015
Consumption and Wealth

Source: BEA, 2015Q2 2nd release, Fed Flow of Funds
Source: BEA, 2015Q2 2nd release
Conventional Monetary Policy

Source: St. Louis Fed FRED system
Quantitative Easing, Operation Twist

The Other Side of the Fed Balance Sheet

Policy Uncertainty

Europe

Figure 1. The Escalating Cycle of Turmoil

Buildup Of Stress → Crisis Begins → Policy Response → Relief → Political Resistance

Sources: Bloomberg L.P.; and IMF staff estimates.
ECB Drives Down Sovereign Yields

Source: ECB
The Current Puzzle

Federal debt held by public, to GDP ratio [left scale]

Ten year minus exp'd inflation

TIPS