Financial Crises
ECON 4673
Dr. Keen

Answers

1. *How does the concept of asymmetric information help to define a financial crisis?*

   Asymmetric information problems (adverse selection and moral hazard) are always present in financial transactions but normally do not prevent the financial system from efficiently channeling funds from lender-savers to borrowers. During a financial crisis, however, asymmetric information problems intensify to such a degree that the resulting financial frictions lead to flows of funds being halted or severely disrupted, with harmful consequences for investment and economic activity.

2. *How can a decline in real estate prices cause deleveraging and a decline in lending?*

   A decrease in real estate prices lowers the net worth of households/firms that own the real estate assets. That resulting decline means that households/businesses have less at risk and, as a result, are more willing to take on risk at the lender's expense. In addition, lower net worth reduces the value of the collateral and so the adverse selection increases. The decline in real estate prices can make borrowers less credit-worthy and can cause a contraction in lending. The real estate decline can also lead to a deterioration in financial institutions' balance sheets, which causes them to deleverage (reduce their amount of lending). That reduction further contributes to the decline in lending and economic activity.

3. *What is a credit spread? Why do credit spreads rise significantly during a financial crisis?*

   Credit spreads measure the difference between interest rates on risk-bearing bonds, such as corporate bonds, and risk-free Treasury securities. The rise of credit spreads during a financial crisis (as occurred during the Great Depression and again during 2007–2009) reflects the escalation of asymmetric information problems that make it harder to judge the riskiness of corporate borrowers and weakens the ability of financial markets to channel funds to borrowers with productive investment opportunities.

4. *What particular financial innovation led to the development of the subprime mortgage market?*

   The securitization process, where mortgage loans are bundled together and sold as security, created an environment where the originators of a mortgage loan did not bear the risk of default. As a result, loan originators were willing to lend to anyone regardless of their credit worthiness. As a result, the subprime lending market was born.

5. *What are the benefits of macroprudential policies that require countercyclical capital requirements?*

   Over the business cycle, lending increases substantially in expansions and decreases substantially in recessions. If countercyclical capital requirements were initiated, bank capital requirements would be higher during economic expansions, which would reduce lending and help prevent credit bubbles from forming. On the other hand, capital requirements would be lowere when the economy goes into a recession so as to encourage more lending and facilitate faster economic growth.