Lecture 3

1. How can the entire system be endangered if just a few banks or financial institutions have solvency or liquidity problems?

When a bank has long term loans or other illiquid assets and short term liquid liabilities such as deposits it creates a situation where a bank panic can occur. This so called "run on banks" occurs when bank depositors lose faith in the bank's assets people run and pull out their money and cannot pay everyone because it cannot change its loans into cash quickly. The bank will either fail or take huge losses. This happened in 2008 because banks were so linked together over subprime mortgages, when people doubted the investors there were "runs" on banks disrupting the financial markets.

2. Describe the various elements of the policy response to the financial crisis.

The fed took lessons from the great depression responses and they needed international cooperation. The G-7 countries agreed to prevent the failure of systemically important financial institutions, ensure financial institutions access to funding and capital, restore depositor confidence and work to normalize credit markets. These announcements brought bank lending rates down and restored interbank lending confidence.

3. Describe the role of the traditional tool of the discount window in halting bank runs. Why was additional action needed?

The discount window is used lend and provide liquidity to banks. It is used routinely to provide short term funding for banks if per se they ended the day and needed a loan overnight. At the discount windows banks borrow at the "discount rate". The discount window is always there and operative. During the crisis the maturity of discount windows loans was extended and interest rates reduced in order to provide even more liquidity. Regular auctions of the discount window funds were conducted to encourage broad participation by all financial firms.

4. What are the alternative tools? How were they intended to prevent potential bank runs?

The fed had to go beyond a discount window and create programs to provide further liquidity to firms and loans were "secured" by collateral. These were through special credit and liquidity facilities. The purpose was to calm the panic by providing liquidity. This was done to enhance the stability of the financial system, promote availably of credit to us households and businesses, as the central bank has always functioned as the lender-of-last-resort. The difference was it took place in different institutions context. During the crisis banks were covered by the discount window but other broker-dealer firms needed lending as well. Asset backed security market dried up but the fed aided with liquidity to return it to normal.

5. Summarize the effects of the financial crisis on the real economy. Compare and contrast those effects with the effects of financial crises during the Great Depression.
Crisis: The world went into a recession. U.S. Gdp fell a total of more than 5% from its peak to through. Manufacturing output declined nearly 20 percent, and new home construction plummeted 80%. More than 8.5 million lost jobs. Unemployment raised 10% during this time. Other countries had worse recessions than the U.S. and fears of a depression were real.