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WHAT CAUSED THE CRISIS?

A HELICOPTER TOUR

Crisis was caused by many factors

- Good economic conditions before the crisis:
  - Steady growth – *the Great Moderation.*
  - Low and stable inflation.
  - Low long nominal and real interest rates.
  - Declining risk spreads and reduced volatility in financial markets.

- Policy-controlled interest rates were low and tended to be moved gradually.
  - Steady increase in predictability of monetary policy.

Fertile environment for risk-taking

- Lower capital market yields provided investors with incentives to raise returns.
- Reduced macro economic uncertainty and financial markets volatility meant that risk had declined.
- Low policy-controlled interest rates and predictable monetary policy.

Increased risk taking

- Ways to raise risk & return:
  - Raise leverage.
  - Buy higher-yielding & riskier products.
    - Financially engineered products, in many cases tied to booming US housing market.
    - Extremely complex and opaque but AAA rated.

Financial sector

- Severe incentive problems:
  - Originate-to-distribute model.
  - Compensation schemes & short horizons.
- Excessive reliance on short-term funding.
- Inadequate attention to liquidity risk.

Other factors

- Overreliance on ratings by end users.
- Excessive closeness between rating agencies and debt issuers.
- Poor or non-existent regulation and supervision.

Economic developments

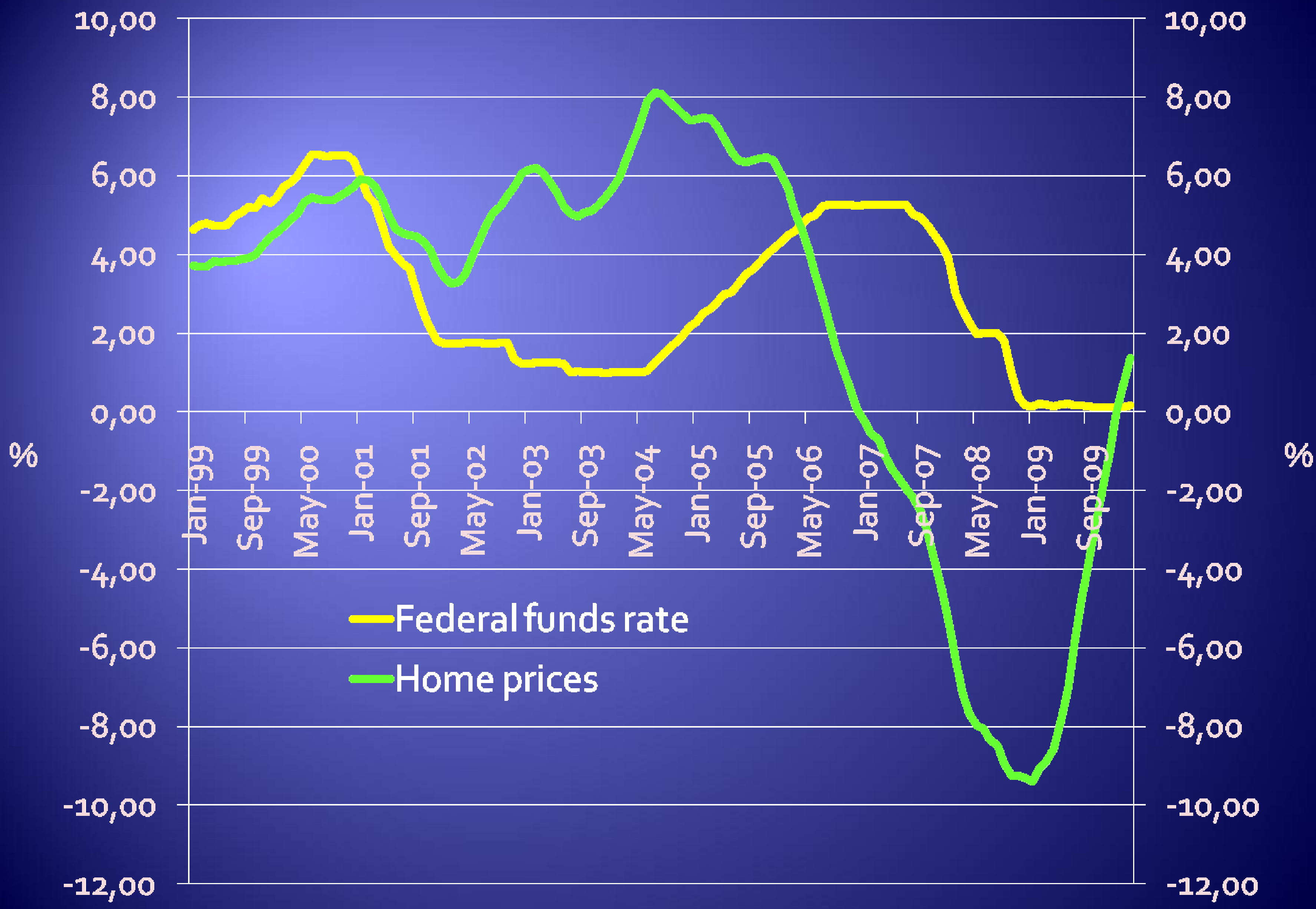
- Many factors contributed to structural weaknesses in the financial sector.
- Global imbalances led to massive capital flows through financial system.
  - Current account surpluses among oil exporters, in China and Japan (and elsewhere in Asia), in Germany …

The Fed …

- Monetary policy had been very expansionary in the US followed the burst of the “dot-com” bubble in 2001.
  - Risk of deflation.
  - Associated with rising property prices.

… raises interest rates

- Starting in June 2004, the Fed raised interest rates from 1% to 5.25% …
- … and housing prices started falling.
- Non-recourse mortgages.



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Federal funds rate
Home prices

Summary

- Crisis was caused by a range of factors:
  - Excellent macro economic and financial conditions that lulled people into complacency.
  - Incentive problems in financial sector.
  - Weak regulation and supervision.
  - Global imbalances that fuelled the fire.
  - Monetary policy makers focused too narrowly on inflation.