Prof. Dr. Stefan Gerlach
Institute for Monetary and Financial Stability, University of Frankfurt

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