Financial Crisis and a monetary stimulus by US Federal Reserve Harvard Case Solution & Analysis

What happened?

Causes

1.Housing Bubble-Between 1998 and 2006, the price of the typical American house increased by 124%.

During the two decades ending in 2001, the national median home price ranged from 2.9 to 3.1 times median household income. This ratio rose to 4.0 in 2004, and 4.6 in 2006 This housing bubble resulted in many homeowners refinancing their homes at lower interest rates, or financing consumer spending by taking out second mortgages secured by the price appreciation.

Consequences

Actions Taken

The discount rate were reduced to 1% and 1.75%, respectively. Central banks in England, China, Canada, Sweden, Switzerland and the European Central Bank (ECB) also resorted to rate cuts to aid the world economy. But rate cuts and liquidity support in itself were not enough to stop such a widespread financial meltdown.

The U.S. government then came out with National Economic Stabilization Act of 2008, which created a corpus of $700 billion to purchase distressed assets, especially mortgage-backed securities. Different governments came out with their own versions of bailout packages, government guarantees and outright nationalization.

Northern Rock

Lehman Brothers

CDO

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What happened?

- The financial crisis happened because banks were able to create too much money, too quickly, and used it to push up house prices and speculate on financial markets. Banks created too much money
- Every time a bank makes a loan, new money is created. In the run up to the financial crisis, banks created huge sums of new money by making loans. In just 7 years, they doubled the amount of money and debt in the economy.
- Banks started questioning the viability of their counter-parties. They and other sources of wholesale funding began to withhold short-term credit, causing those most reliant on it to founder.

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Fall in output: The $6 trillion to $14 trillion base estimate of lost output following the crisis depends on assumptions about the economy's trend rate of growth and whether an oil-price shock in 2008 might have caused a mild recession anyway. This estimate of the aggregate cost of the crisis covers 2008 to 2023, when output is assumed to fully return to trend.

Decrease in capacity: Non-farm payrolls fell by more than 8.7 million, or 6.3 percent, and the number of unemployed climbed to 14.7 million over the course of the recession, peaking at 10 percent of the nation's labor force in October 2009.In July 2013, four years after the recession is deemed to have ended, labor under utilization remains intractably high: 11.5 million people are unemployed and an additional 10.6 million are underemployed or frustrated.

The crisis resulted in a significant loss of trust in government institutions and the U.S. capitalist economic systems

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Northern Rock

Treasury and the Bank of England promised to help every bank hit by the credit crunch. Northern Rock lended a large amount for mortgages, and finances this with money from banks and savers. Northern Rock receives a relatively small amount of money from savers. Money markets stopped lending money to Northern Rock due to the crisis in the US sub-prime mortgage market. The Bank of England had to Step into the breach and gave Northern Rock an emergency loan.

Lehman Brothers

It took a year for the financial crisis to come to a head but it did so on 15 September 2008 when the US government allowed the investment bank Lehman Brothers to go bankrupt. Up to that point, it had been assumed that governments would always step in to bail out any bank that got into serious trouble: the US had done so by finding a buyer for Bear Stearns while the UK had nationalised Northern Rock.

CDO

Then banks created a financial product called CDO using all these subprime mortgages. a synthetic product - pooled all of the lowest tranches (highest interest payments, highest risk) together. The theory behind this is that even though the assets behind the bonds are risky, by pooling large amounts together it is possible to minimize risk whilst still receiving the high interest rates.

Much of the problem with CDOs in the mid 2000s was that they were assigned AAA ratings whilst being based on less-than-investment grade assets. The reasons for the rating agencies giving these CDOs top ratings were: Conflict of interest - the issuer of a CDO is not obliged to take any rating assigned to it, therefore the issuers would always use the best rating they could obtain, so the agency giving the highest rating was paid the fees
Faulty Models - Historical data suggested that no more than 4-6% of homeowners would default, so the holders of the AAA tranches which required default rates of 15% or higher were assumed to be entirely safe. However, once US house prices fell, subprime borrowers defaulted en masse

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From 2000 to 2003, the Federal Reserve lowered the federal funds rate target from 6.5% to 1.0%. between 1996 and 2004, the U.S. current account deficit increased by $650 billion, from 1.5% to 5.8% of GDP.Trade deficits required the U.S. to borrow money from abroad, in the process bidding up bond prices and lowering interest rates.

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