Financial Crisis

Class 3: FED Interventions to Financial Crisis

Pop Economics

EVROPSKÁ UNIE
Evropské strukturální a investiční fondy
Operační program Výzkum, vývoj a vzdělávání

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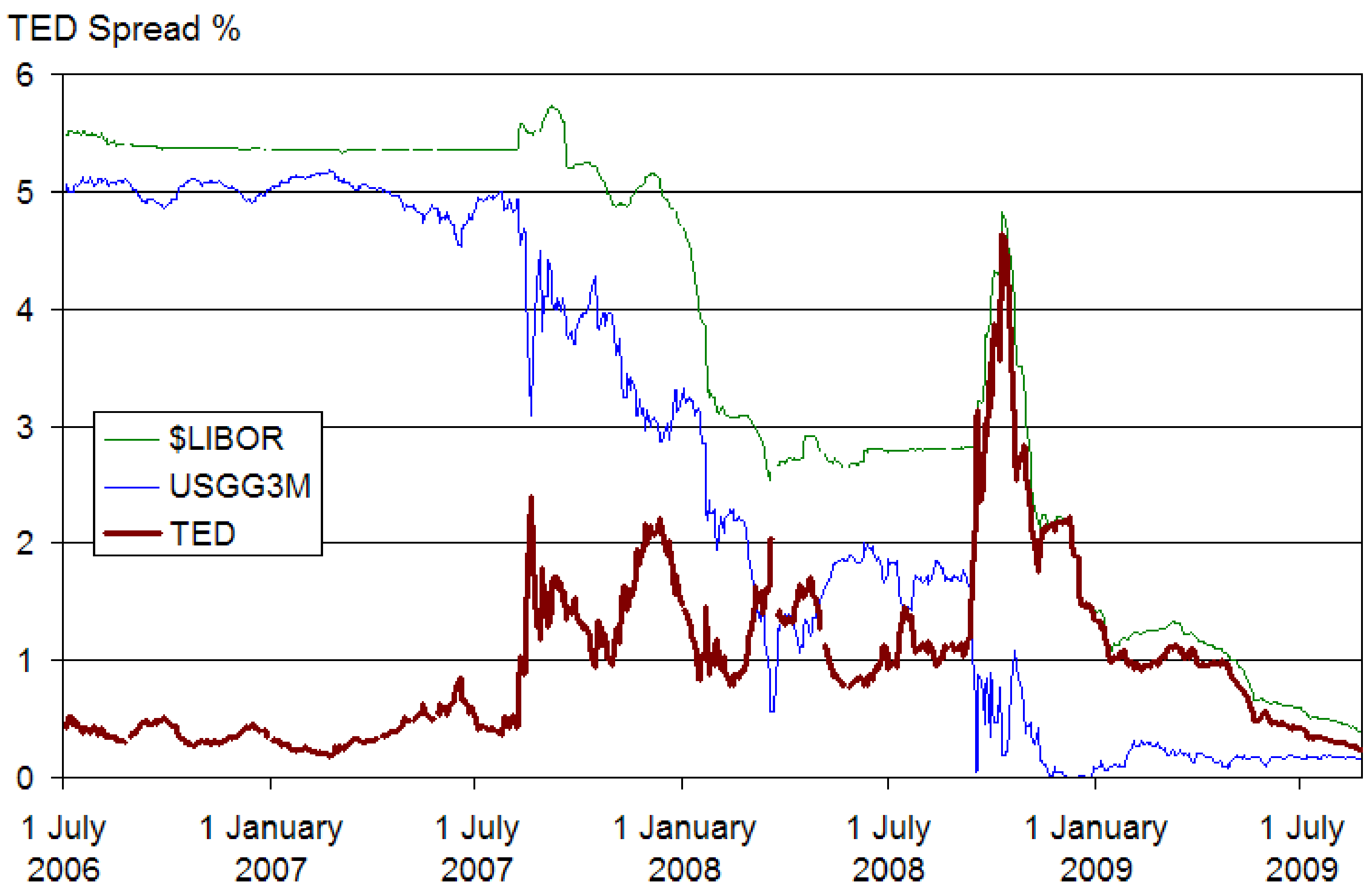
Financial crisis spreads

- **Financial crisis turns into global crisis**
  - Cause: trading with toxic securities, esp. CDO

- **Financial crisis spreads into the entire economy:**
  - Distrust in the interbank market in 2008/ 1Q 2019, fear of bankrupcy of other banks, fear of financial loss → banks increased interest rates → **credit crunch or credit freeze**
  - Investment became more expensive
  - Fear of investment

Credit crunch



Source: https://en.wikipedia.org

Way to fight against impacts of crisis

- Economic policy
  - Fiscal policy
  - Monetary policy

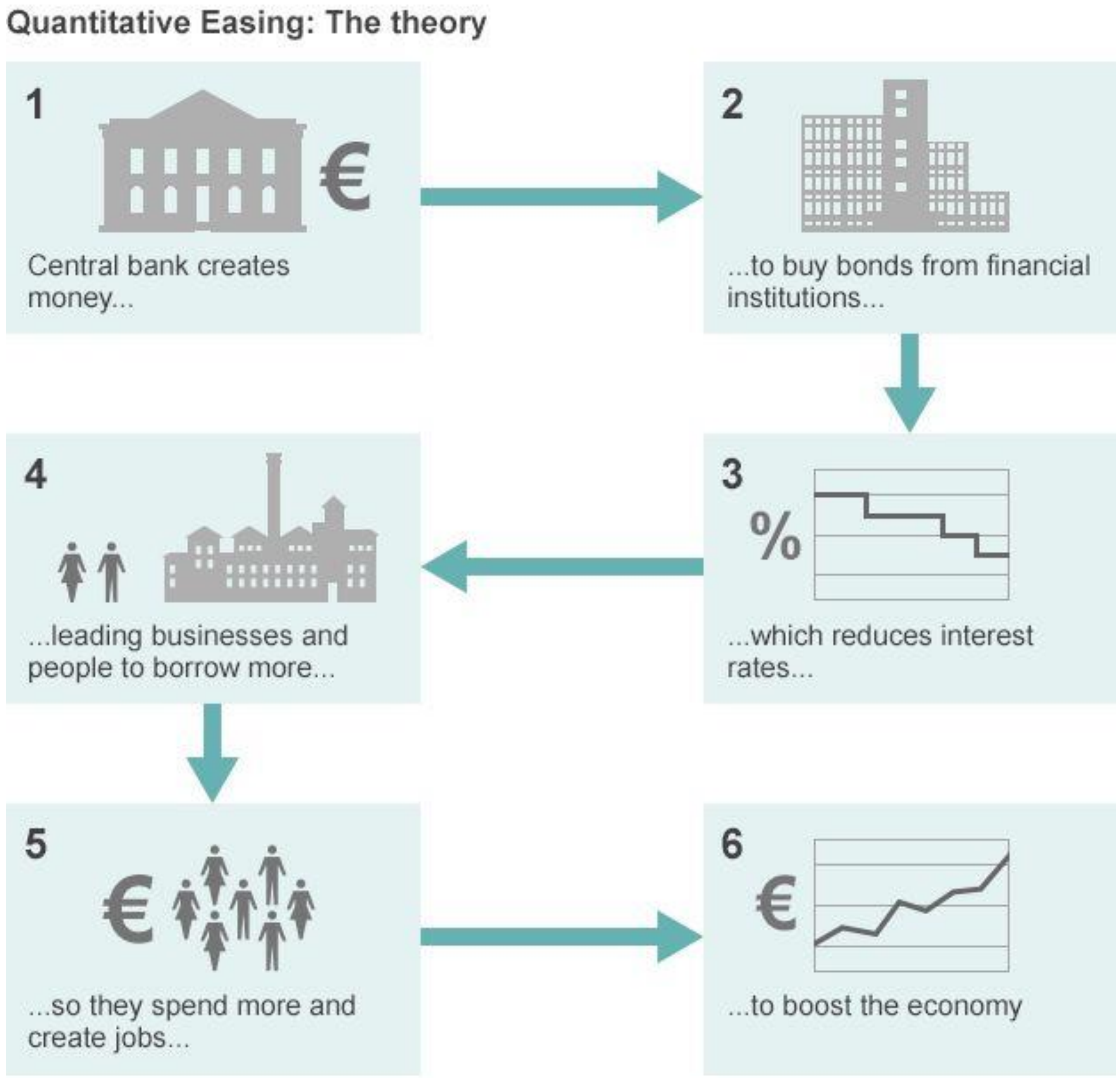
- Bubble in 2006/2007 caused insecurity and „**animal spirits**“ in the market (Smith, fear of getting poor)
- Monetary policy: FED intervention
- Without FED impacts of bubble bursting would be worse

Response of FED: short-term interest rates lowering

- Different psychology of FED and commercial banks: FED has no private ownership linkage: disposes with “public money“ and did not have fear of loss
- Intervention of FED in 2009: decrease of **short-term** interest rate and provision of cheaper credits in interbank market
  - Aim: provide more credits, support more investment, support growth
  - Risk of cheap credits: investment which does not make economic sense
- Short-term interest rate influence the long-term interest rate (i.e. mortgages), but only partially. There are other factors.

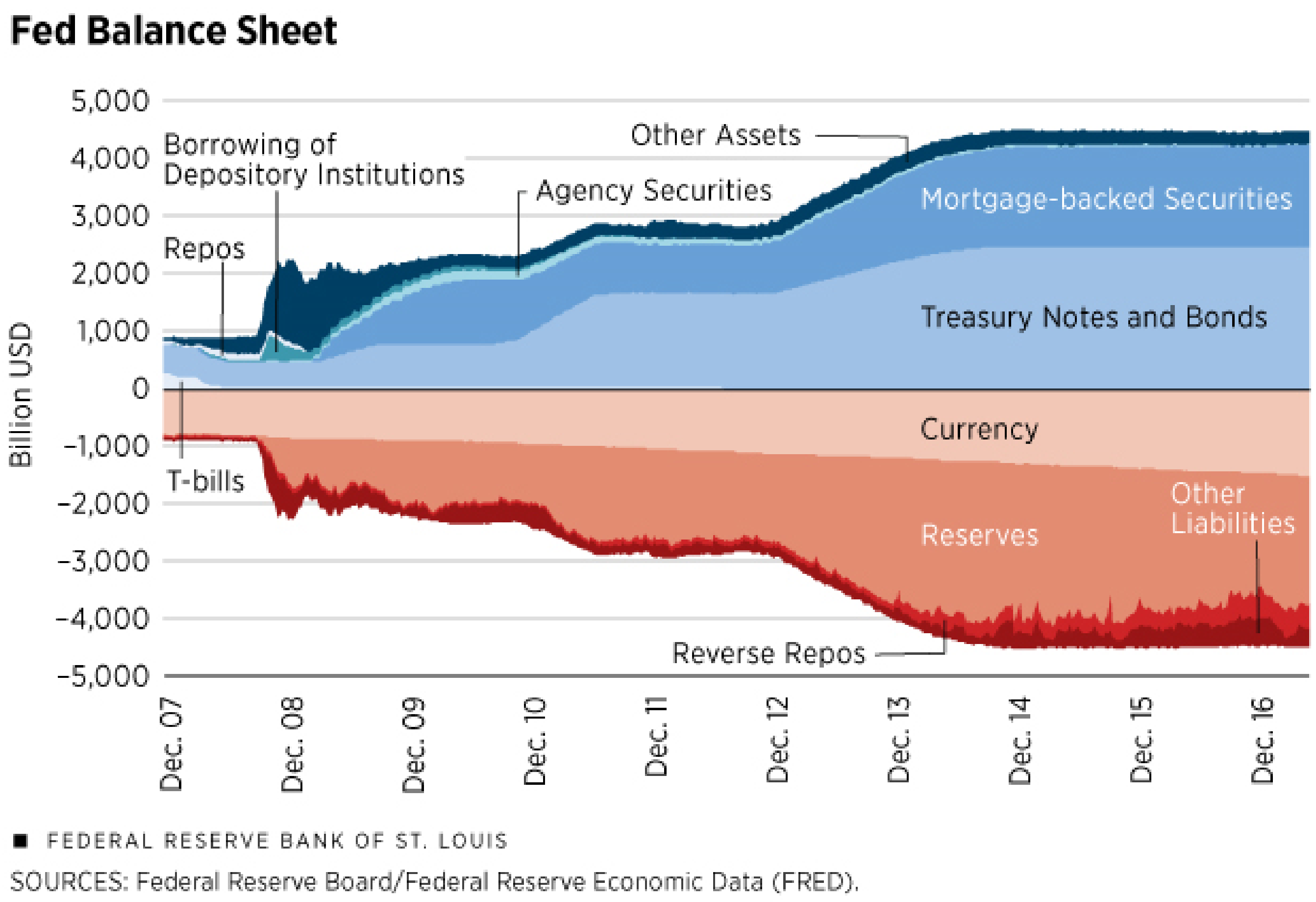
Response of FED: long-term interest rates lowering

- Quantitative easing (QE)
- FED created money and bought bonds and MBS in large amounts (morgage backed securities)
- The lower profit of bonds are, the lower long-term IR (mortgages) in economy is.


Quantitative Easing: The theory
1
€
Central bank creates money...
2
...to buy bonds from financial institutions...
3
%
...which reduces interest rates...
4
...leading businesses and people to borrow more...
5
€
...so they spend more and create jobs...
6
€
...to boost the economy

Source: BBC

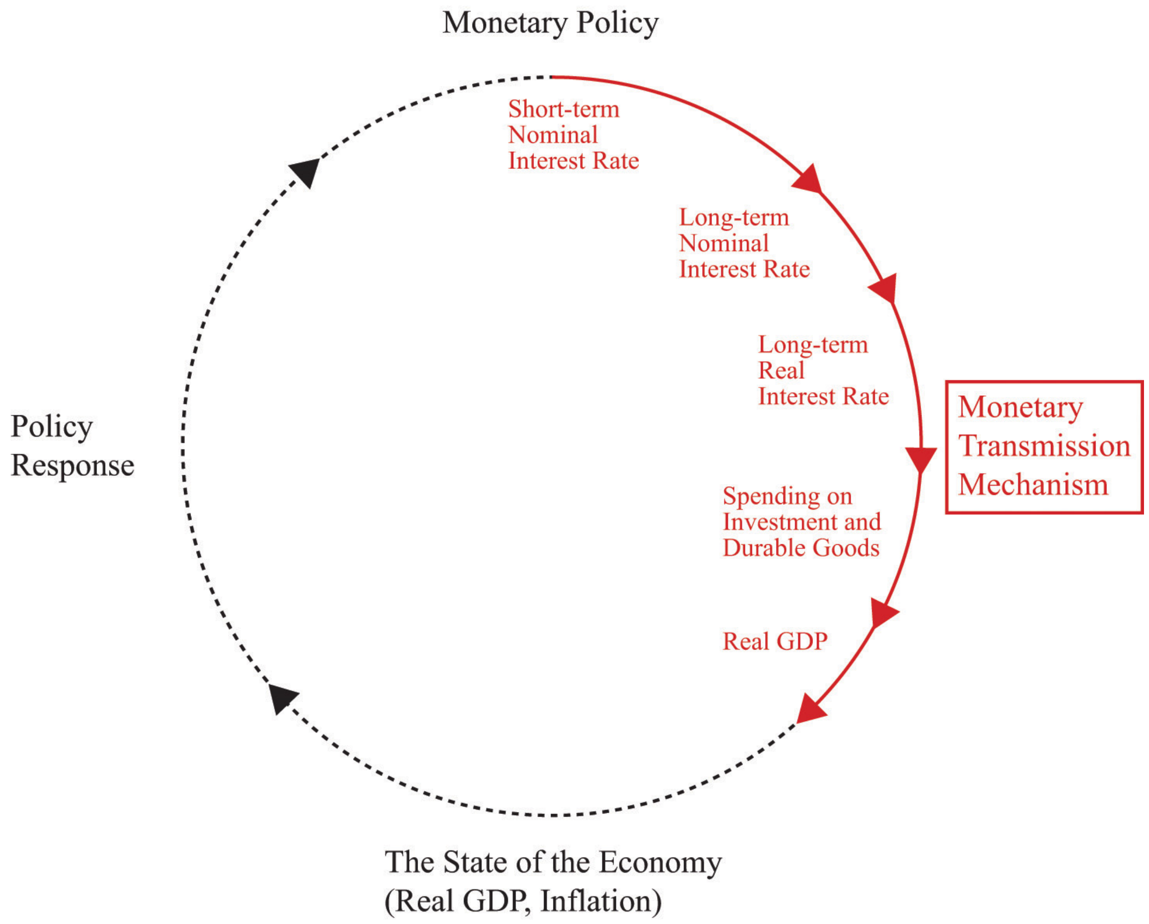
Quantitative easing (QE)



Source: https://www.stlouisfed.org

Transmission mechanism of monetary policy

- Problem: new dollars issued, interbank market easing, but the money did not go to the real economy
- No guarantee that the transmission mechanism of monetary policy will work



Source: saylordotorg.github.io

Helicopter money

- central banks making payments directly to individuals
- alternative to quantitative easing
  - **liquidity trap**: interest rates near zero, economy in recession

What to remember

- credit crunch, credit freeze
- long- and short-term interest rates
- interest rates and impacts of their decrease and increase
- quantitative easing
- bond
- helicopter money
- transmission mechanism

Národohospodářská fakulta VŠE v Praze