The Financial Crises of 2008 – 20XX?

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Recession 2007-2009

THE GREAT RECESSION

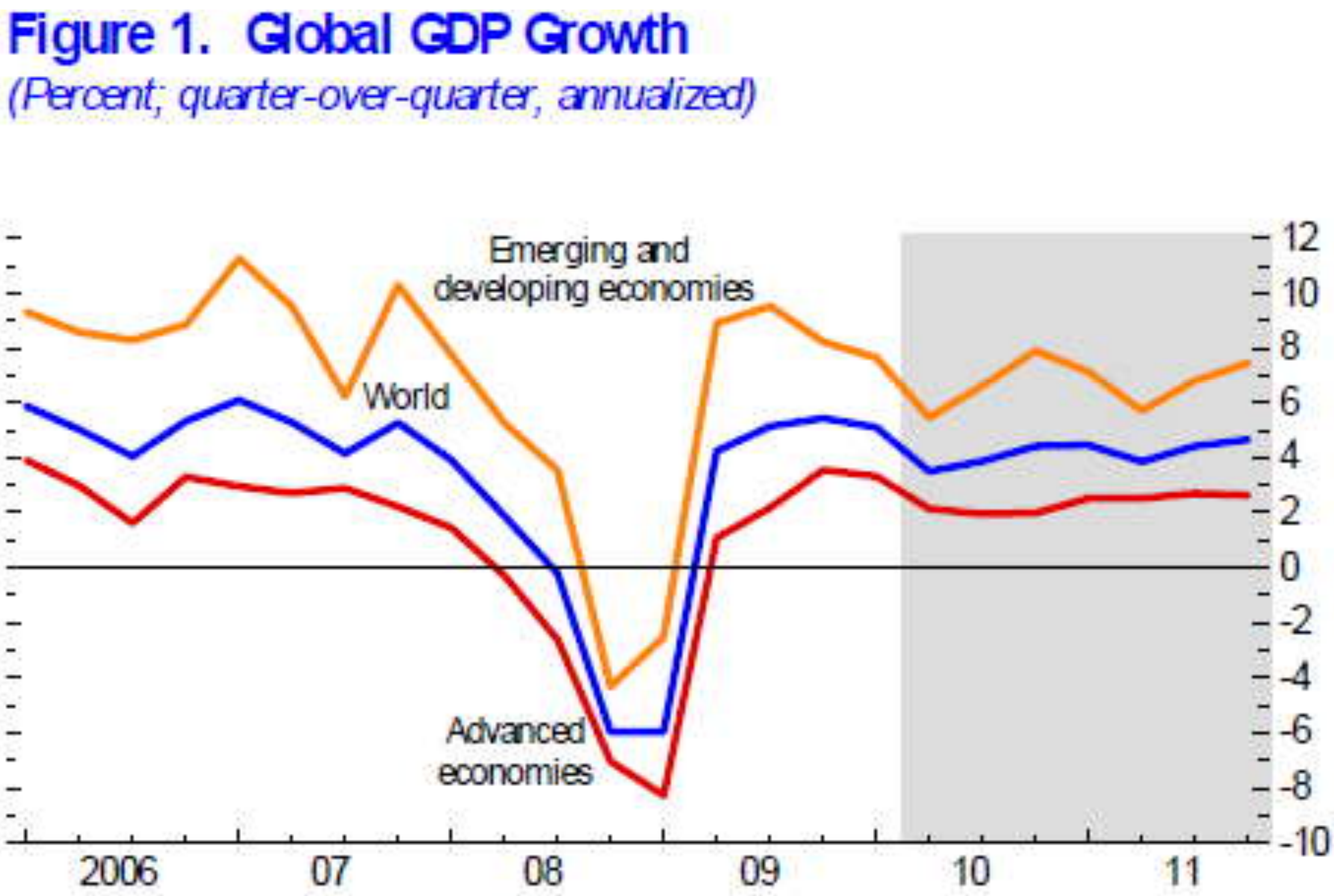
- Two shocks
  - Commodities and oil price shock
    - pushes up prices, and pushes down output
  - Credit crunch
    - Fall in credit / lending
    - pushes down demand
- Eichengreen (April 2009)

"...the world is currently undergoing an economic shock every bit as big as the Great Depression shock of 1929-30."

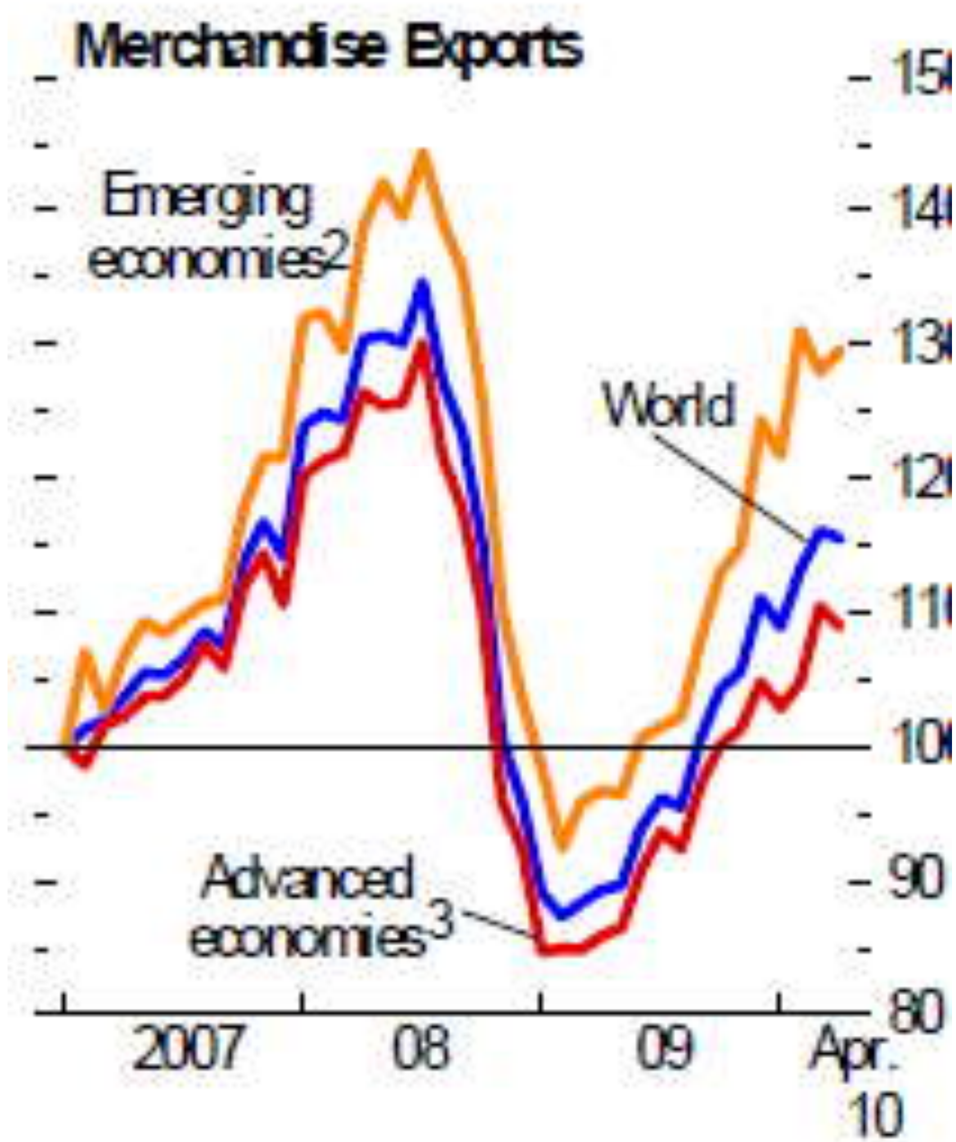
Ingredients

- Global imbalances (deficit / surplus countries)
  - Brettons-Woods II
  - Oil exporters
- Low long term interest rates and loose credit
- More credit chasing same amount of assets (financial, real estate)
  - Bubble in fin assets, real estate
  - Monetary authorities (Fed, MPC (BoE), ECB) did not respond as CPI growth low
  - Change in way mp set in future?
- Poor allocation of credit
  - Sub-prime

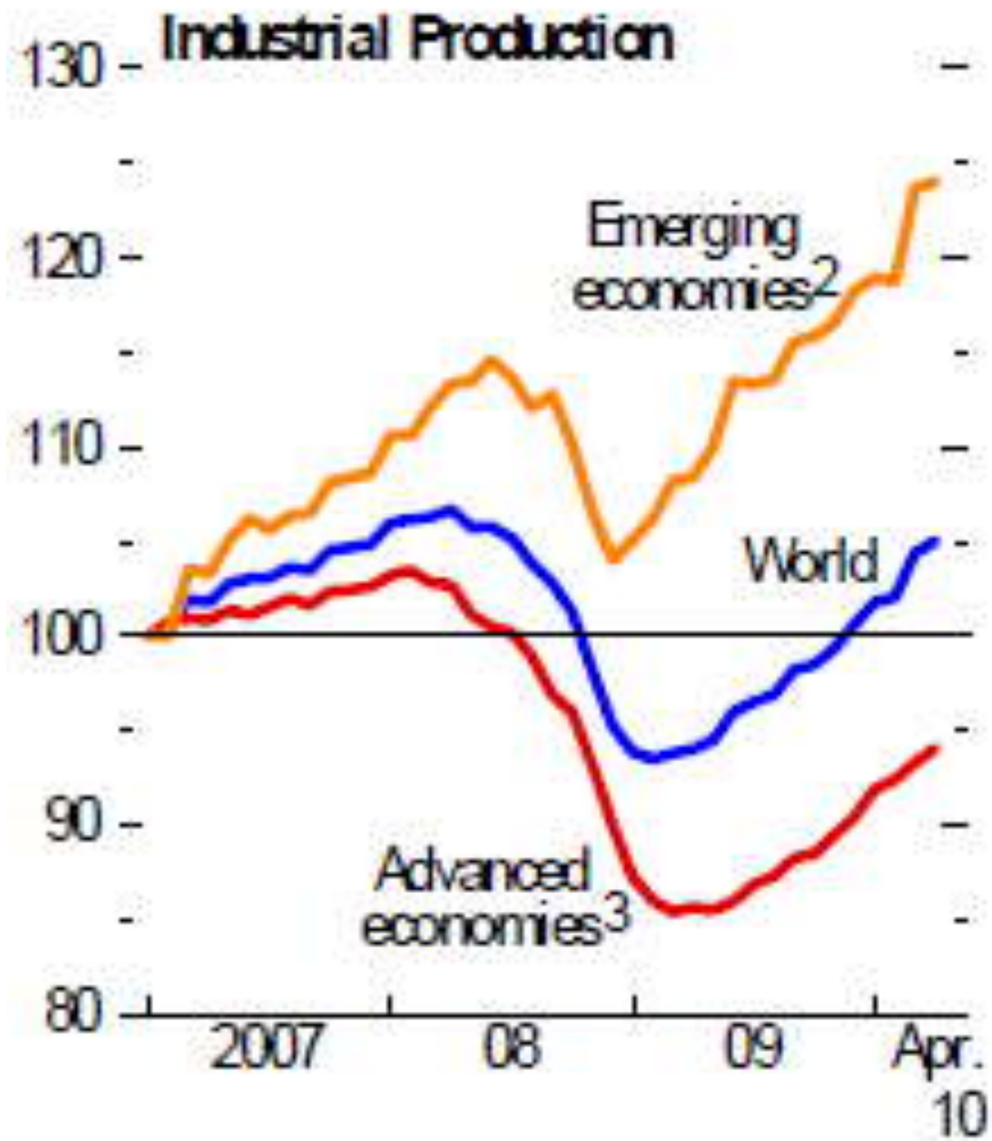
IMF Global Growth, July 2010

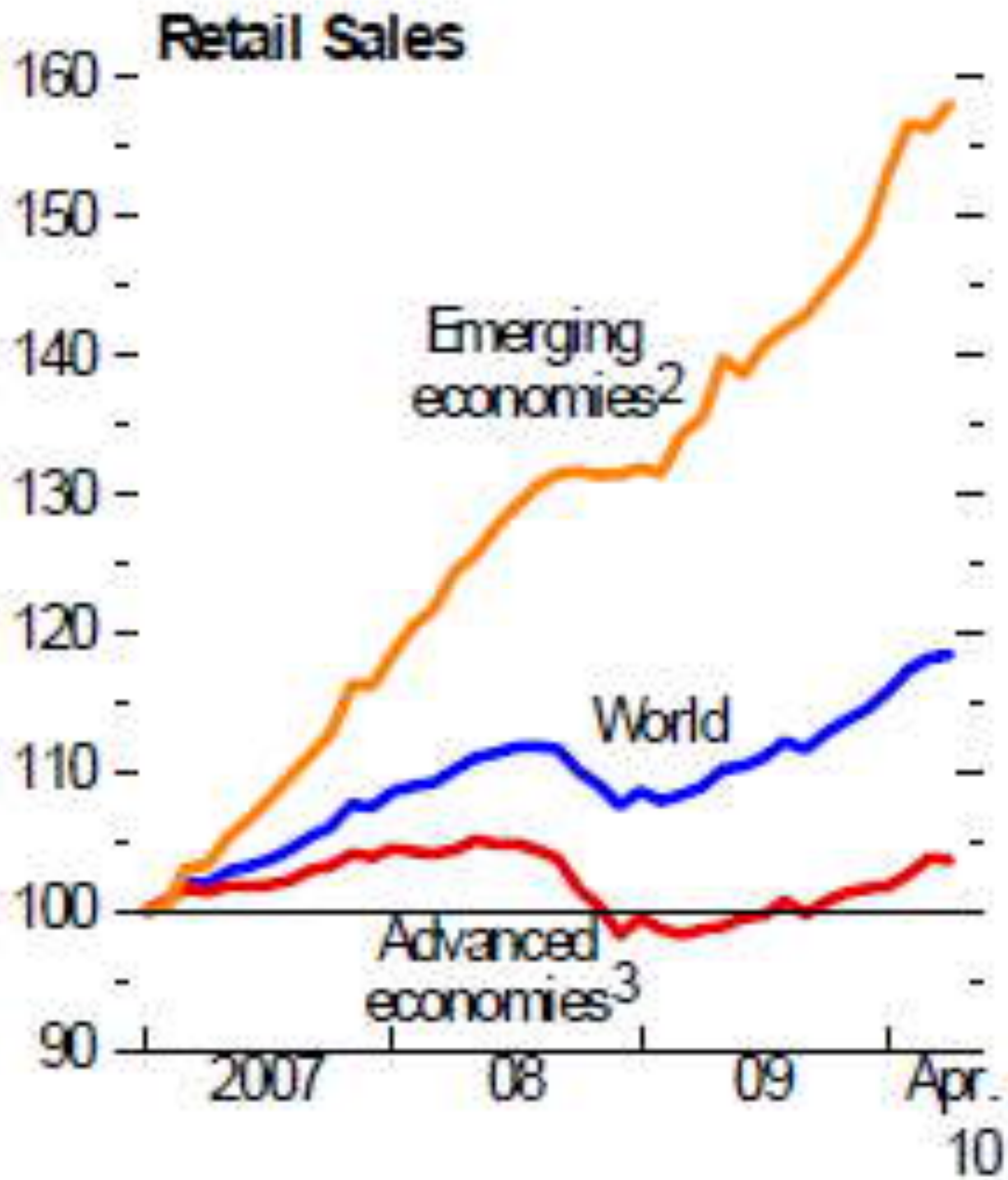


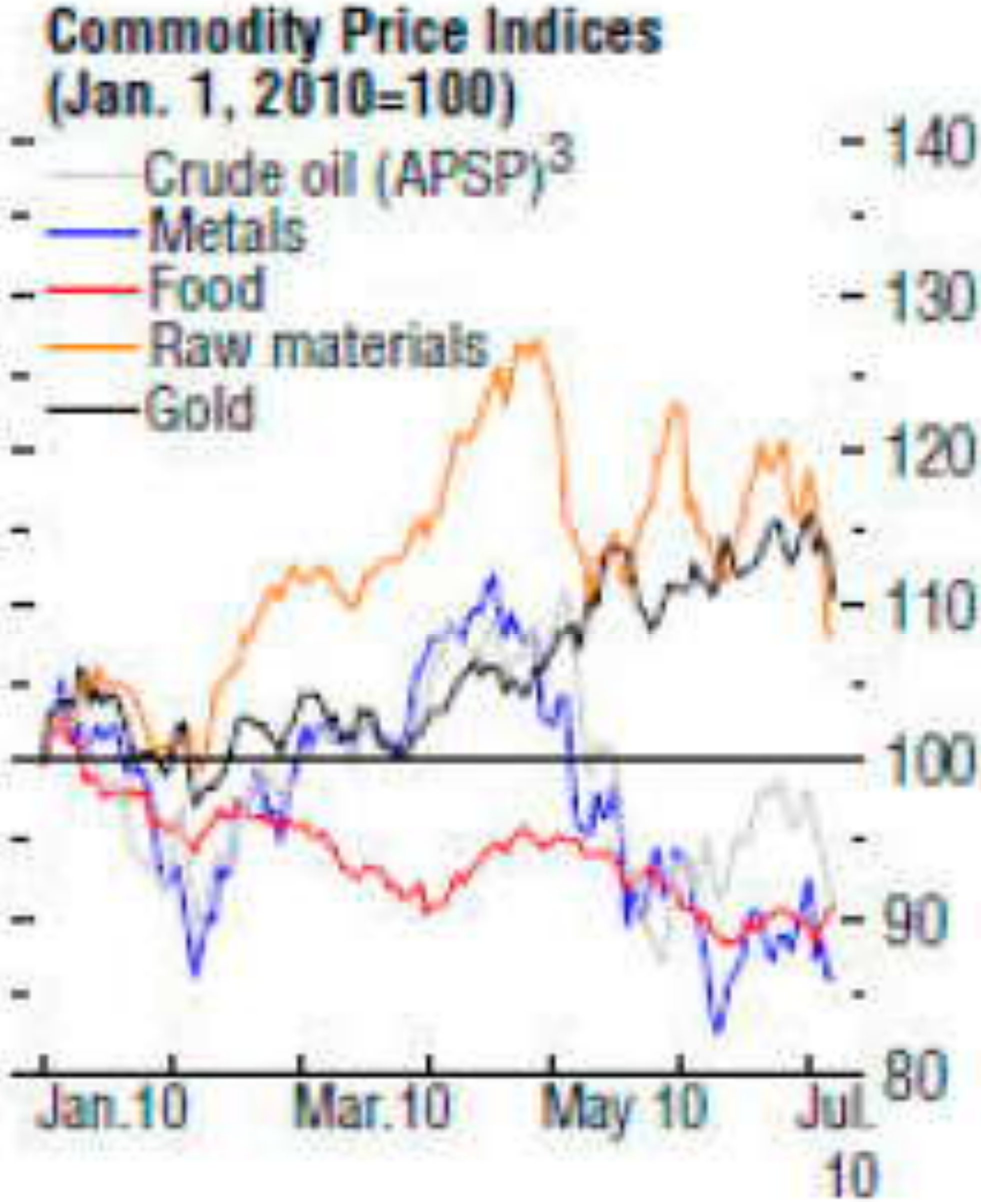
Merchandise Exports

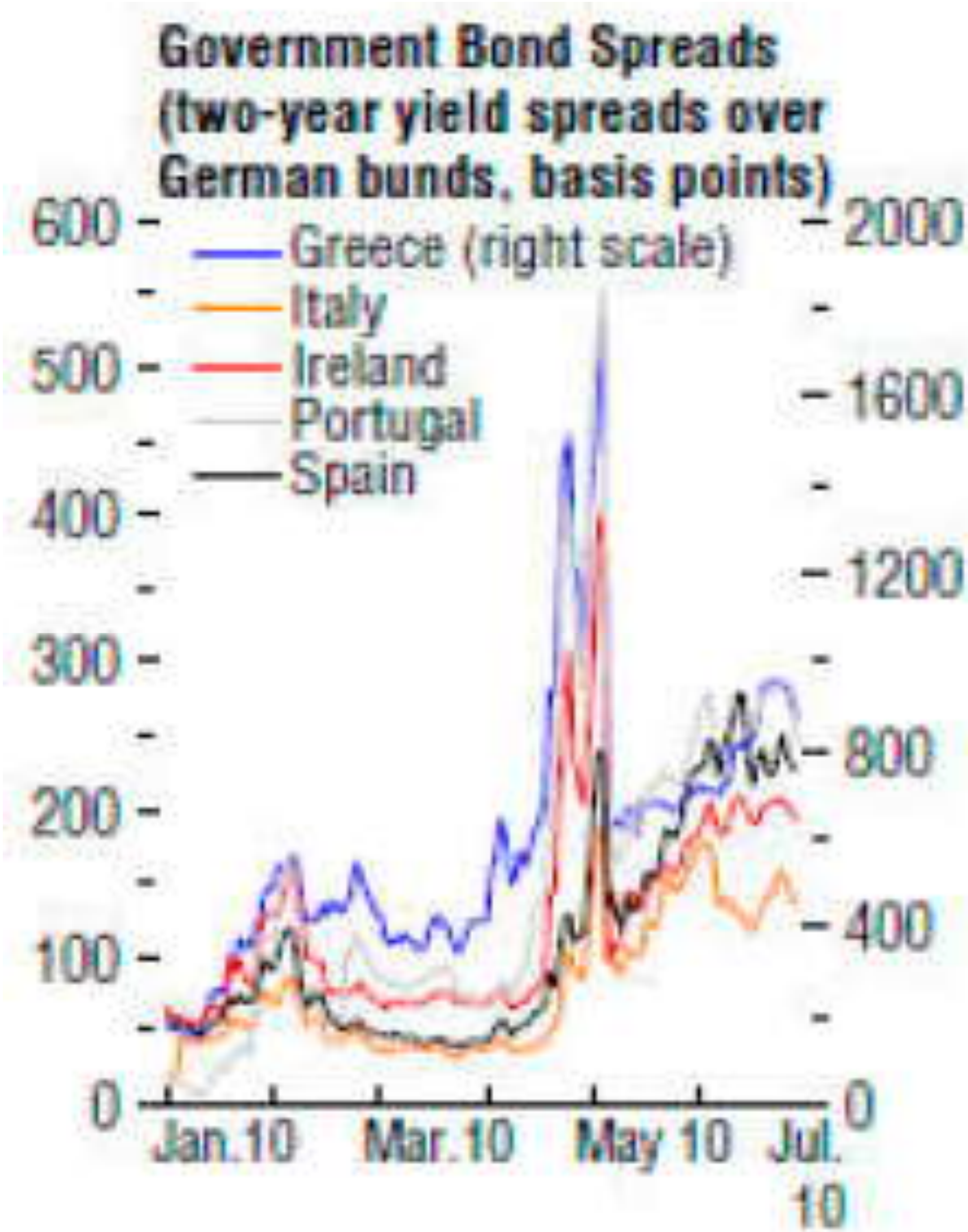


Industrial Production



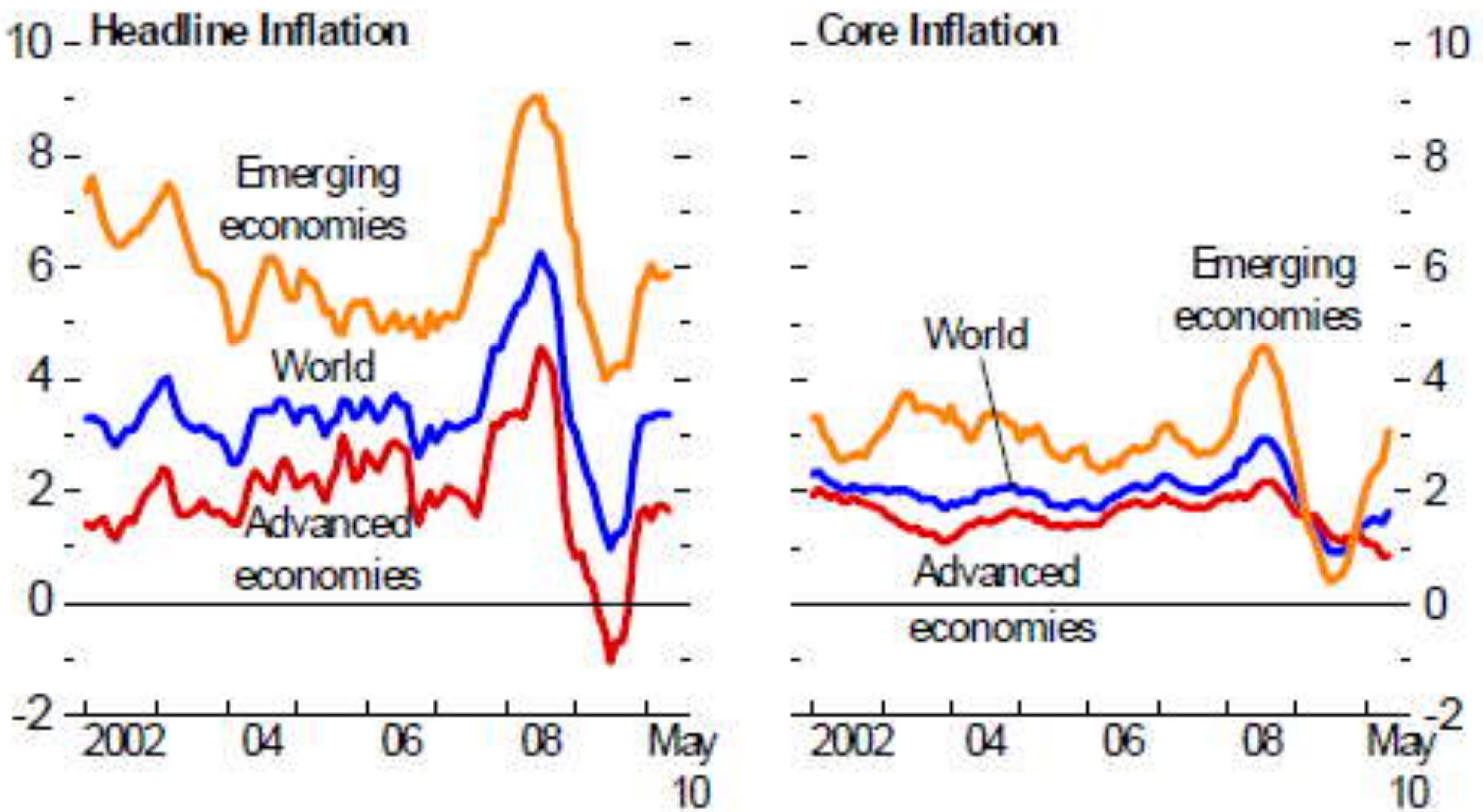

Retail Sales
160
150
140
130
120
110
100
90
Emerging economies2
World
Advanced economies3
2007
08
09
Apr. 10

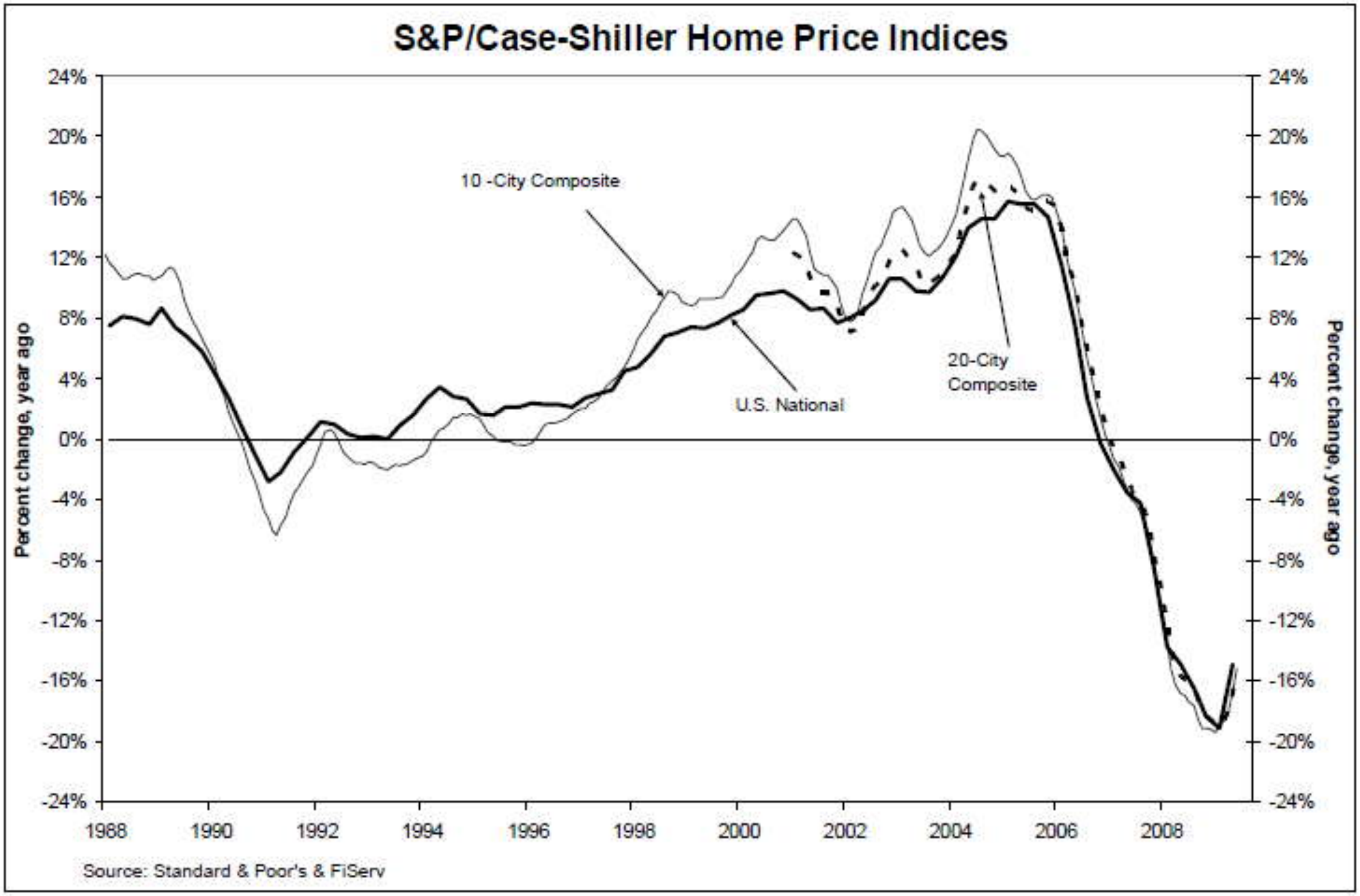

Commodity Price Indices
(Jan. 1, 2010=100)
Crude oil (APSP)3
Metals
Food
Raw materials
Gold
140
130
120
110
100
90
80
Jan.10
Mar.10
May 10
Jul.
10


Government Bond Spreads
(two-year yield spreads over
German bunds, basis points)
Greece (right scale)
Italy
Ireland
Portugal
Spain
600
500
400
300
200
100
0
2000
1600
1200
800
400
0
Jan.10
Mar.10
May 10
Jul.
10

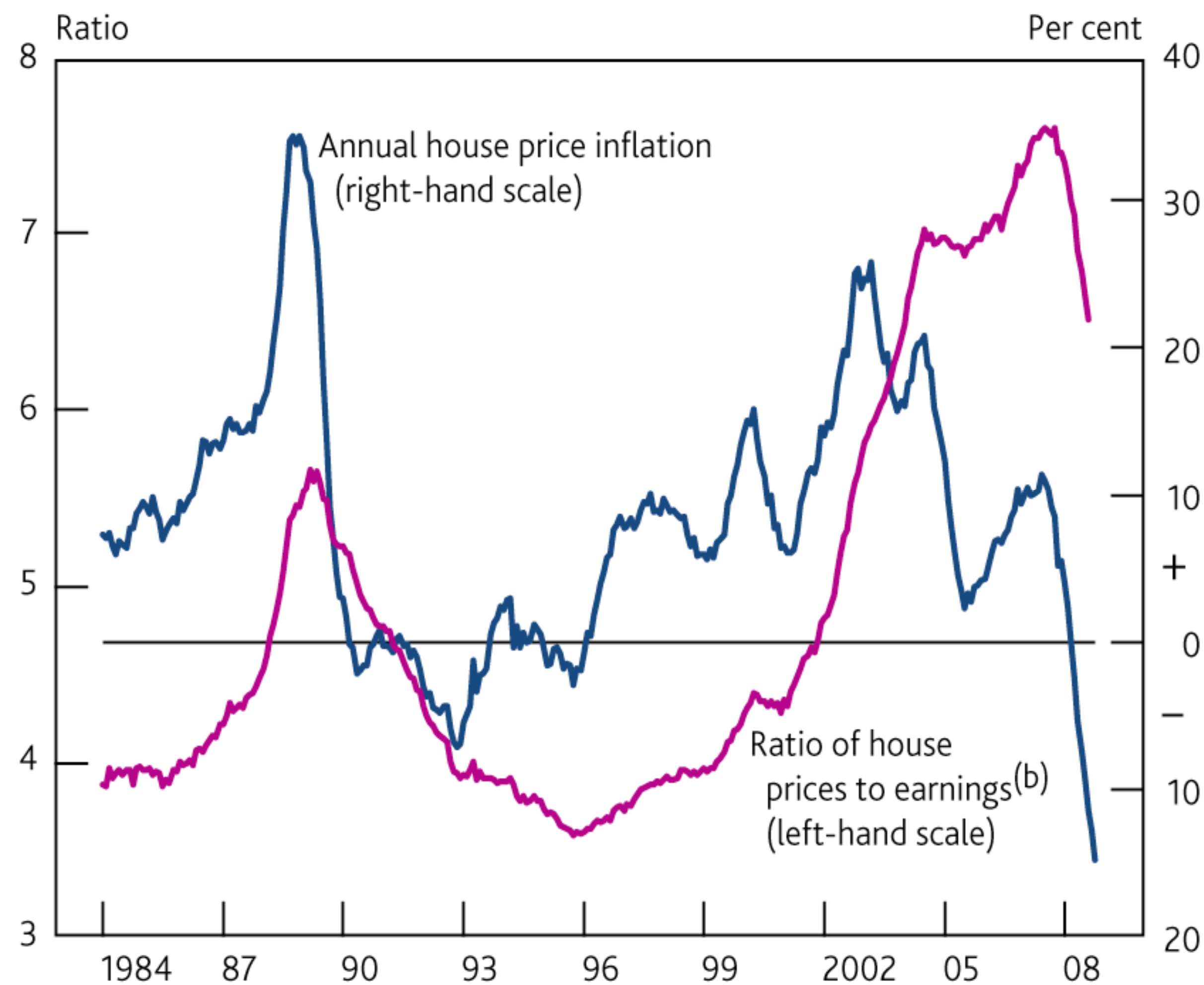
Global Inflation

year on year




S&P/Case-Shiller Home Price Indices
24%
20%
16%
12%
8%
4%
0%
-4%
-8%
-12%
-16%
-20%
-24%
Percent change, year ago
10 -City Composite
U.S. National
20-City Composite
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
Source: Standard & Poor's & FiServ

House prices and earnings

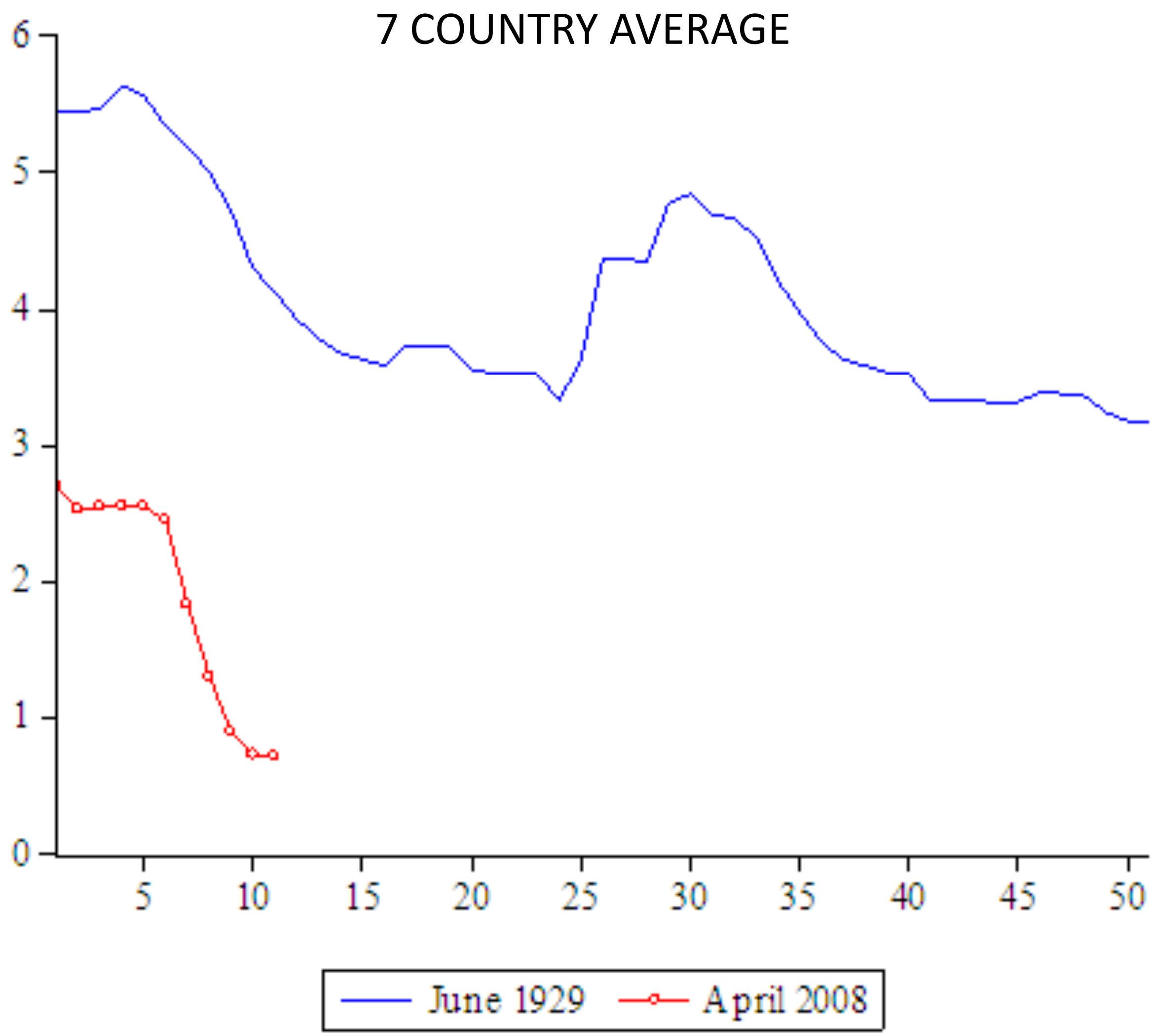


Sources: Halifax, Nationwide, ONS and Bank calculations.

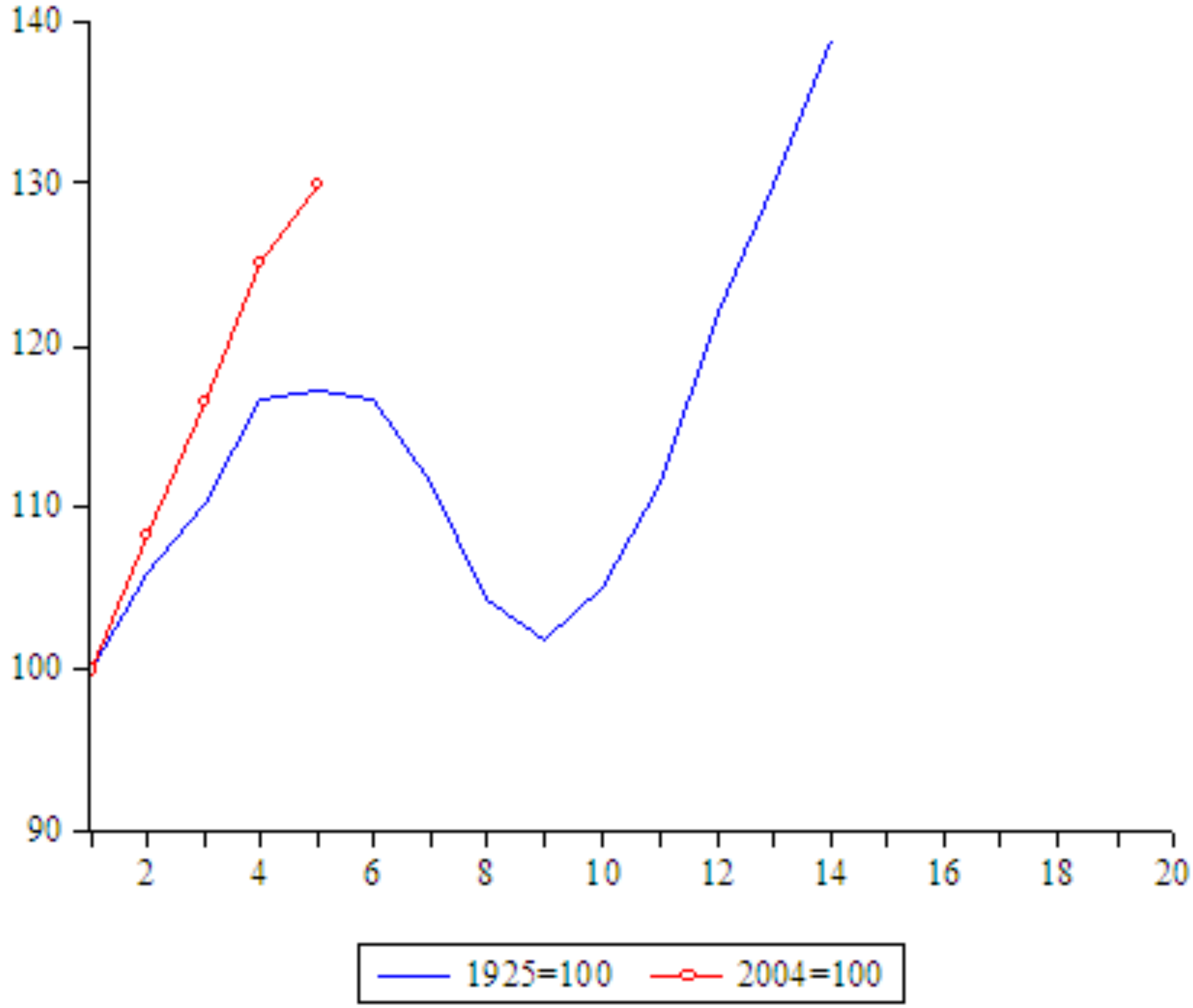
(a) House prices are based on the average of the Halifax and Nationwide measures from 1991 onwards. Prior to that, the Halifax measure is used as the Nationwide measure is not available at a monthly frequency. The published Halifax index has been adjusted in 2002 by the Bank of England to account for a change in the method of calculation.
(b) Average house price divided by average annual earnings. Average annual earnings based on the 2007 annual survey of hours and earnings (ASHE) and the average earnings index (AEI).

Central Bank Interest Rates

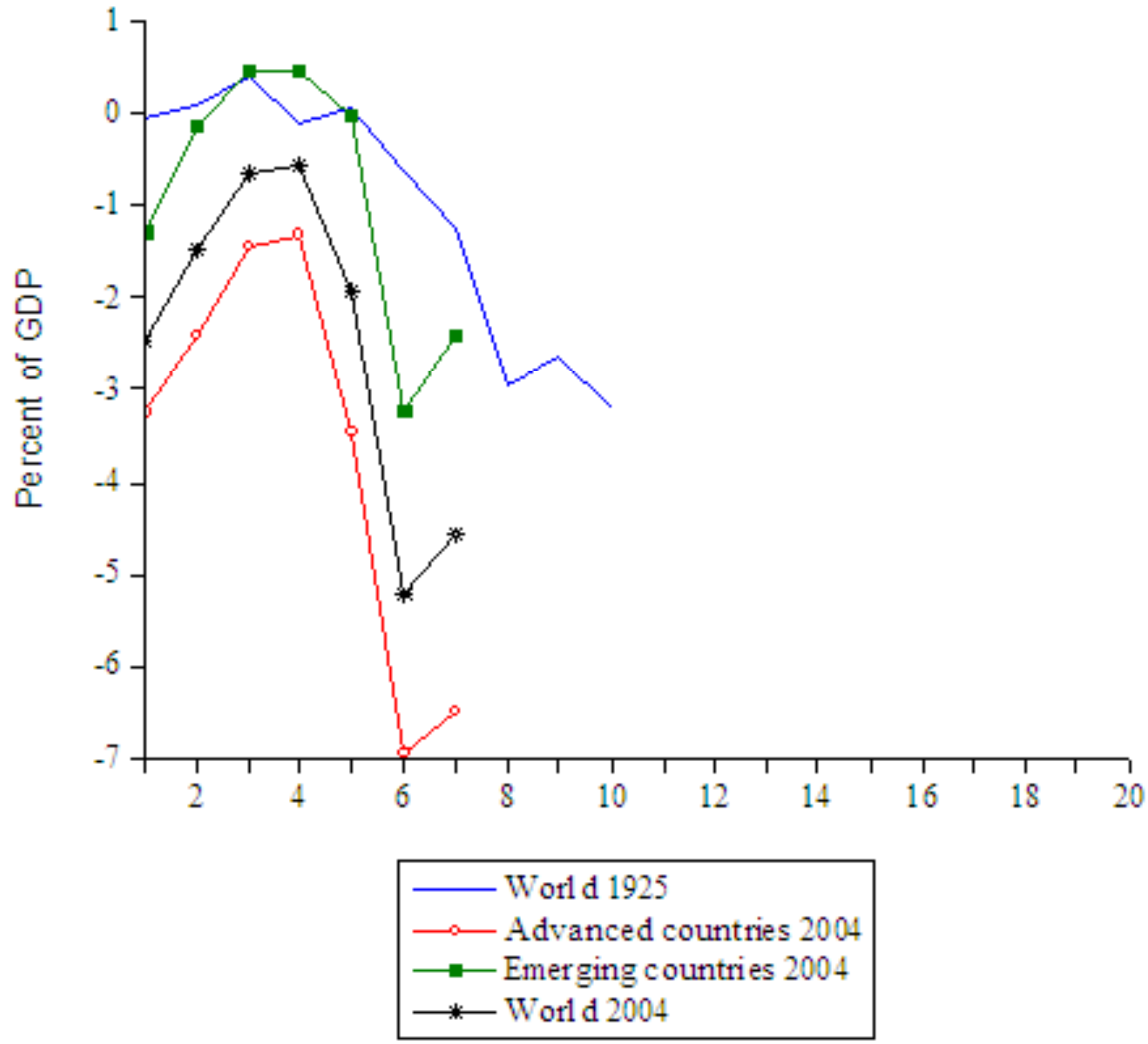
NOW vs THEN



Money Supplies, 19 Countries: NOW vs THEN

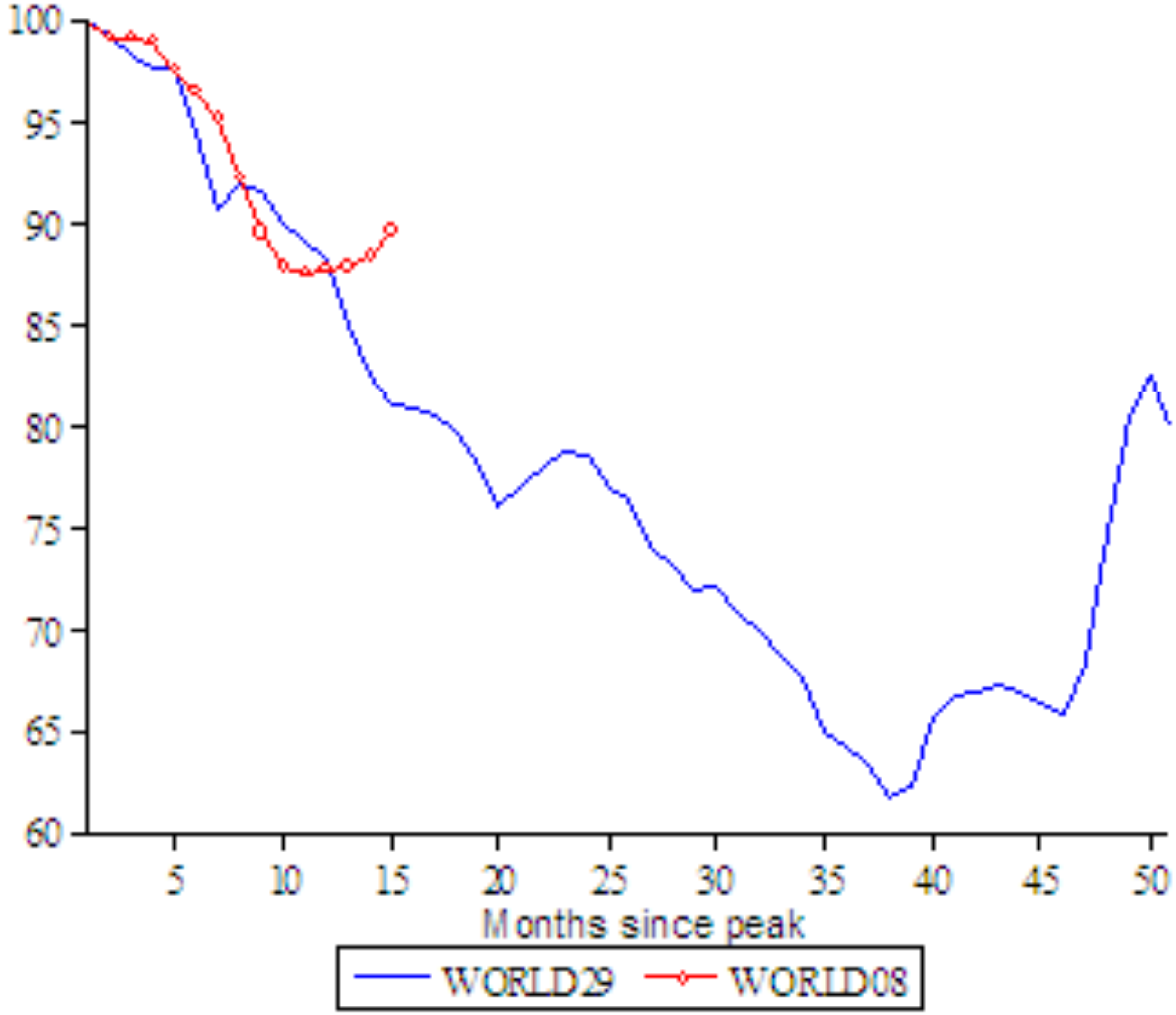


Government Budget Surpluses NOW vs THEN

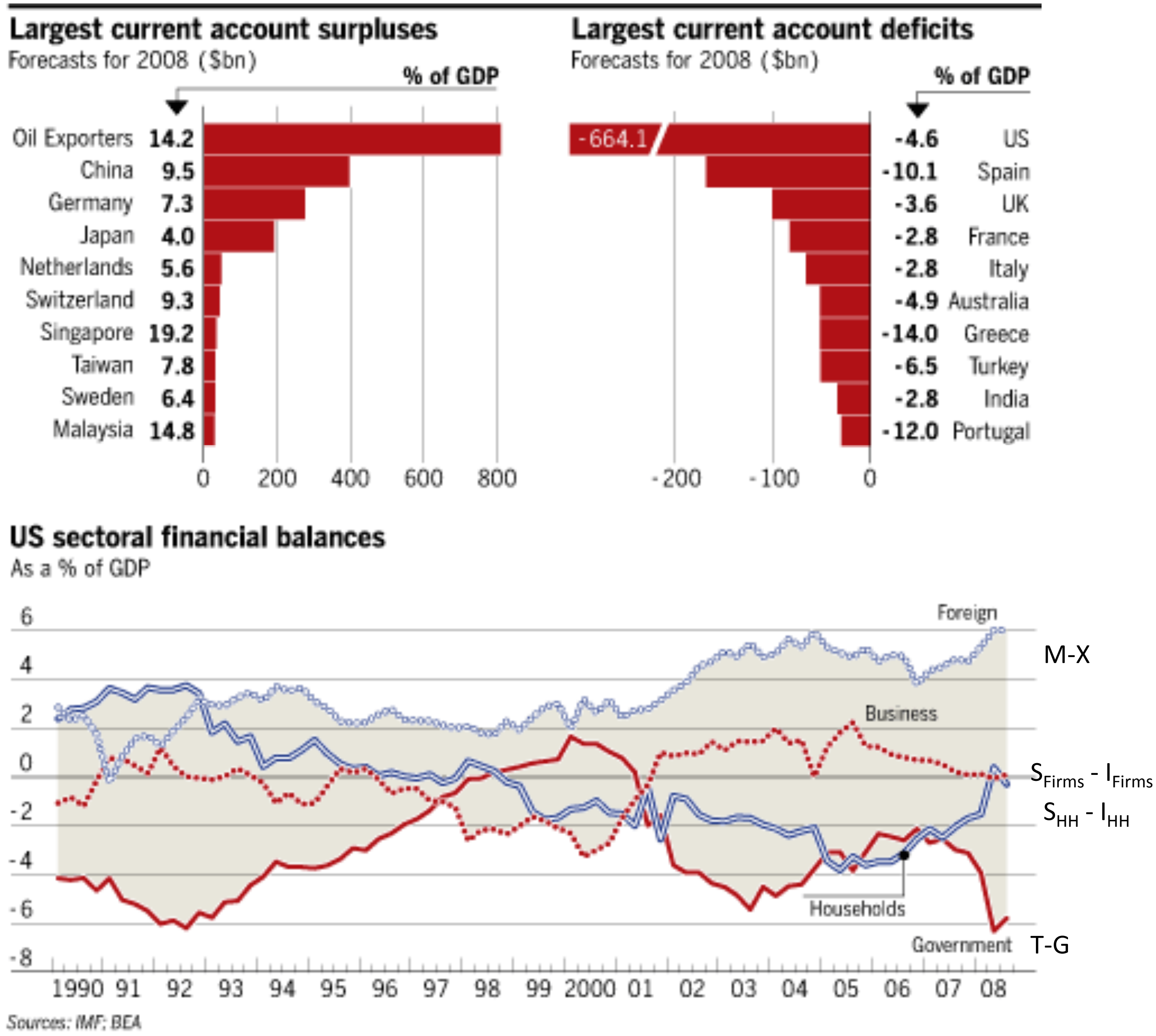


World Industrial Production

NOW vs THEN



Global Imbalances



A Basic Macro Identity

$$Y = C + I + G + EX - IM$$

Income = Expenditure

supply of goods = demand for goods (loosely)

(Y can be more or less than Y_f)

Exports (EX) decrease with ↑ in real exchange rate (RER)

Imports (IM) increase with ↑ real exchange rate

RER = e.P/P*

Trade Balance = EX - IM

↑RER => ↓(EX – IM)

Causes of Global Imbalances I

- Bretton Woods II
  - export-led growth (China, etc)
  - lower exchange rate to make exports more competitive
  - switch demand from foreign to home goods (e.g. from US to China)
  - USA: CA deficit (EX-IM < 0 or spend more than earn)
  - China: CA surplus (EX – IM > 0; spend less than earn = saving too much)

Causes of Global Imbalances II

- Oil Exporters
  - gulf states: pulse of income from oil now

  EX – IM > 0

  Spending less than income: Y < C + I + G + EX – IM

  (saving for the future)

  For the world as a whole INCOME=EXPENDITURE

Implication of Global Imbalances

- $Y_{CH} = C_{CH} + I_{CH} + G_{CH} + EX_{CH} – IM_{CH}$

China $\downarrow$exch. rate => $\uparrow$ $(EX_{CH} – IM_{CH})$

(demand switching)

- $Y_{US} = C_{US} + I_{US} + G_{US} + EX_{US} – IM_{US}$

Effect on spending of US goods?

US Policy Response

- $Y_{US} = C_{US} + I_{US} + G_{US} + EX_{US} – IM_{US} < Y_f$ (full emt)

- US runs loose monetary policy (lower interest rates) to stimulate I_{US} (investment)

- result I: sub-prime (investors chasing yield)
- bubbles in property, and stock, markets

Blowing Bubbles

- Low long term interest rates and loose credit
- More credit chasing same amount of assets (financial, real estate)
- Quantity Theory of Money: MV=PY

  M – broad aggregate of money

  – ↑M, V,Y fixed → ↑P
  – spending directed at financial assets, real estate; not goods and services
  – Monetary authorities (Fed, MPC (BoE), ECB) did not respond as CPI growth low
  – Change in way mp set in future?
    - additional target: financial stability

Financial Crisis Part II

- Financial crisis Part I
  - first major shock: mid-2008
- Financial Crisis Part II
  - GIPS (Greece, Ireland, Portugal, Spain)
  - high unemployment
    - 20% in Spain
  - high ratio of government debt to GDP
- US???!!!!

Stress within Europe

- Euro area – common monetary policy
- Germany, France: return to positive growth
- Greece, Ireland, Portugal, Spain (GIPS)
  - low or negative growth
  - High unemployment (approaching 20%)!
  - very high government debt / GDP
  - part of euro area so can't devalue!!

Euro: Fundamental Problem

- common currency
  - fixed exchange rate system
- limited scope for adjustment of competitiveness
  - control wage growth
  - v. painful
- RER: measures cost of goods in Greece relative to Germany

e = exchange rate (if member of Euro, e = 1)

p = price level in Greece

p* = price level in Germany

Options for the GIPS

- $Y_f = C + I + G + EX - IM$

- Can’t increase G: no one will buy bonds

- Can’t increase EX – IM via ↓e: part of eurozone

- only option? austerity

(or default or leave euro)

Implications of FCII for PNG

- financial crisis:
  - PNG banking system is insulated from world credit markets
  - loans are met by PNG deposits

- fall in demand:
  - high demand for energy and metals from China
  - LNG, gulf oil

Internal and External Balance

- Two (macro) objectives for gov't

1. full employment (internal balance)
2. trade balance: exports = imports (external balance)

- govt has 2 levers

1. exchange rate
2. government spending