FEDERAL RESERVE BANK *of* ST. LOUIS

2019 Royal Banks
Economic Forecast Breakfast

Lessons from the Financial Crisis

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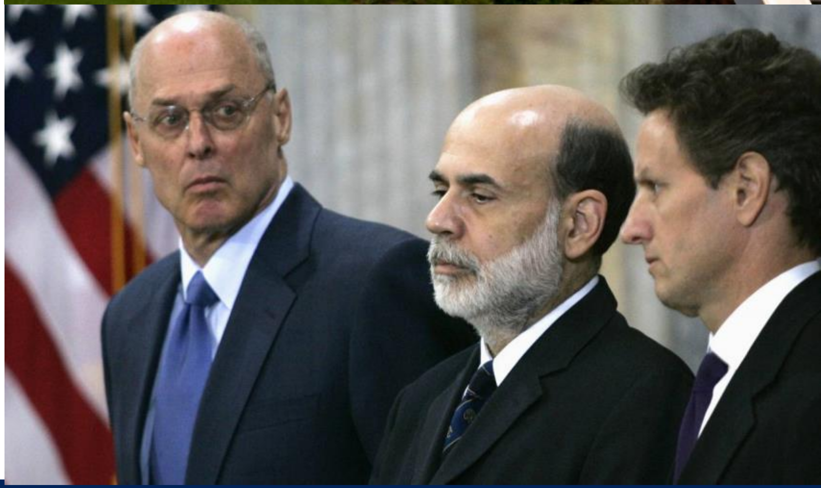
CENTRAL TO AMERICA'S ECONOMY®

Lessons from the Financial Crisis

- What were the most important causes?
- Have we learned and made adjustments?
- Will the next recession be as bad as the last one?



What Caused the Financial Crisis? Ask A Panel of Expert Economists

- **Univ. of Chicago IGM Forum, Oct. 17, 2017**
  (http://www.igmchicago.org/surveys-special/factors-contributing-to-the-2008-global-financial-crisis)

Aaron Edlin	Austan Goolsbee	Darrell Duffie	José Scheinkman	Marianne Bertrand	Ray Fair
Abhijit Banerjee	Barry Eichengreen	David Autor	Joseph Altonji	Markus Brunnermeier	Richard Schmalensee
Alan Auerbach	Bengt Holmström	David Cutler	Judith Chevalier	Michael Greenstone	Richard Thaler
Alberto Alesina	Carl Shapiro	Emmanuel Saez	Katherine Baicker	Oliver Hart	Robert Hall
Amy Finkelstein	Caroline Hoxby	Eric Maskin	Kenneth Judd	Pete Klenow	Robert Shimer
Angus Deaton	Christopher Udry	Hilary Hoynes	Larry Samuelson	Pinelopi Goldberg	Steven Kaplan
Anil Kashyap	Daron Acemoglu	Jonathan Levin	Liran Einav	Raj Chetty	William Nordhaus

- **Instructions: Rank a list of 12 proposed factors that you believe contributed most to the 2008 global financial crisis by importance and by your level of confidence.**
- **A panel of European economists came to similar conclusions.**

Rank by Importance and Confidence

- Accounting: Fair value or mark-to-market accounting for financial assets held by banks
- Bad regulation: Inadequate or flawed regulation, supervision, or both with respect to the financial sector (which includes financial infrastructure, banks, shadow banks, and interconnections in the system)
- Derivatives: Underestimation of the riskiness of securities created with financial engineering
- Fed: Loose monetary policy by the Fed, by central banks around the world, or both
- Global: Imbalances between global savings and well-functioning channels for investing those savings
- GSEs: Government involvement in subsidizing mortgages, homeownership, or both
- Household debt: Elevated levels of US household debt as of 2007
- Housing bubble: Inflated beliefs about housing prices
- Mortgage fraud: Bad incentives, fraud, or both in mortgage issuance and securitization
- Rating agencies: Failures by rating agencies
- Run on repo: Funding runs involving short-term liabilities financing long-term assets
- TBTF: A belief by bankers that their institutions were Too Big to Fail

Weighted by Confidence, US + Europe

Initiative on Global Markets

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Economists Blame Financial Regulation

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Richard Spillenkothen, Federal Reserve Director of Banking Supervision, 1992-2006

Class of 1968
Ferguson High School

Testimony of Fed's Rich Spillenkothen to the Financial Crisis Inquiry Commission

"Well into the crisis, when the severity and depth of some large banks' problems were well-known, it appears (based upon FDIC's published aggregate problem bank assets) that <u>none of the very largest commercial banks, including those that received exceptional government assistance during the crisis, had their CAMELS ratings downgraded to problem bank status</u> – a surprising situation that can only be explained by concern over the impact this could have had on financial markets."

In Sum: Lessons from the Financial Crisis

- "Inadequate regulation" was due to
  - Over-reliance on market discipline
  - Underpowered financial supervisors
  - Structural weaknesses in financial markets including the derivatives infrastructure.
- Dodd-Frank and other supervisory efforts addressed these weaknesses but we won't know until the next downturn if it's enough.
- Next recession unlikely to be as bad as last one because the financial system appears strong—but we thought that last time, too.