WHEN YOU'VE SEEN ONE FINANCIAL CRISIS…

CIRANO Note written by Simon van Norden, November 2009

Financial market crises may differ, but severe banking crises typically share many common features. The most recent crisis shares many features with the US Savings and Loan crisis of the 1980s and early 90s as well as some features of the LTCM crisis of 1998. More generally, banking crises are commonly associated with real estate market collapses.

The 2008 crisis began with a fall in US house prices; from its peak in 2006 average US house prices have fallen by about 1/3. The fall has had a profound effect on the US mortgage market. Latest figures from the US Mortgage Bankers Association (MBA) for 2009Q2 showed 13.54% of all residential mortgages were delinquent or in foreclosure. That's the highest rate since the MBA survey started in 1972 and it excludes properties that have left foreclosure (i.e. been repossessed and resold.) MBA note that the problem is continuing to shift from the smaller and riskier sub-prime ARM loans to the much larger prime fixed-rate loans that make up the bulk of the US mortgage market. Given the poor outlook for unemployment, they expect these figures to continue to climb for some time. Deutsche Bank estimates that at the end of 2009Q1 25% of US homeowners with mortgages owed more on their mortgages than their houses were worth. The problem is expected to worsen: futures prices in late August 2009 predicted further price declines on the order of 5-10% for the coming year.

The trouble in the US mortgage market has been bad for US banks. Over 80 US banks have failed so far in 2009; the rate is still increasing with an average of 4-5 failing per week through the summer. While that may seem serious, it's worth noting that over 200 failed every year from 1986-2001 during the US Saving & Loan crisis, peaking at 534 failures in 1989.

Nonetheless, the Federal Deposit Insurance Corporation's Deposit Insurance Fund balance fell more than 75% from $52.8 billion to $13.0 from the end of 2008Q1 to 2009Q1. Bloomberg estimates that the bank failures in the following five months cost upwards of 16 billion. Simply covering the costs of the ongoing bank failures will cost billions of dollars per quarter; replenishing the fund will cost tens of billions of dollars. But the overall cost of the crisis to the US government dwarfs the costs of insuring depositors in failed banks. The Congressional Budget Office currently estimates that the US Federal Government Deficit for 2009 will be $11.6 trillion; at 11.2% of forecast GDP, that's the highest level since WWII. Of course, the costs of the crisis extend well beyond the costs to the government. Through July 2009, US employment was down 6.6 million from its peak as the unemployment rate more than doubled from 4.7% in late 2007 to 9.4% in 2009.

Although the financial crisis originated in the United States, its impact has been no better abroad. Output in the G7 and in OECD countries both fell 4.6% over the same period: the UK, Germany, Japan and Italy all suffered declines ranging from 5.5 to 6.5%.

All of the above seem like good reasons to try to avoid financial crises. However, there are also common arguments *against* avoiding financial crises that should be noted. Many important ones are based on the idea of risk tolerance. Businesses and managers tend to adapt their behavior to the amount of risk that they see. Efforts to stabilize financial markets or the economy will therefore be partly offset by businesses taking on more risk. While this is rational for the individual business, the net effect can be to makes crisis prevention harder than it would otherwise be. When the government offers to insure business or individuals against risk, this increase in risk-taking may greatly increase the cost of such insurance.

In the search for ways to avoid future crises, it is useful to remember that financial crises, particularly banking crises typically share many common features. The most recent crisis shares many features with the Savings and Loan crisis of the 1980s and early 90s as well as some features of the LTCM crisis of 1998. More generally, the financial crises in developed economies with the highest costs to governments are banking crises associated with real estate market collapses. Effectively reducing the risk of future crises requires some combination of reducing the potential size of such collapses and the banking sector's exposure to real estate losses.

For more information, we invite you to consult the scientific paper at the following address:

http://www.cirano.qc.ca/pdf/publication/2009s-42.pdf