Anatomy of a financial crisis

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Abstract

This paper provides an asymmetric information framework for understanding the nature of financial crises. It provides the following precise definition of a financial crisis: A financial crisis is a disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities. As a result, a financial crisis can drive the economy away from an equilibrium with high output in which financial markets perform well to one in which output declines sharply. The asymmetric information framework explains the patterns in the data and many features of these crises which are otherwise hard to explain. It indicates that financial crises have effects over and above those resulting from bank panics and therefore provides a rationale for an expanded lender-of-last-resort role for the central bank in which

the central bank uses the discount window to provide liquidity to sectors outside of the banking system.

Sociology of the Financial Market

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