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Prone to Fail: The Pre-crisis Financial System

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Abstract

The financial crisis that began in 2007 was triggered by over-leveraged homeowners and a severe downturn in US housing markets. However, a reasonably well-supervised financial system would have been much more resilient to this and other types of severe shocks. Instead, the core of the financial system became a key channel of propagation and magnification of losses suffered in the housing market. Critical financial intermediaries failed, or were bailed out, or dramatically reduced their provision of liquidity and credit to the economy. In short, the core financial system ceased to perform its intended functions for the real economy at a reasonable level of

failure of market discipline. Finally, I point to some significant positive strides that have been made since the crisis: improvements in the capitalization of the largest financial institutions, a reduction of unsafe practices and infrastructure in the markets for securities financing and derivatives, and a significantly reduced presumption that the largest financial firms will be bailed out by taxpayer money in the future. But I will also mention some remaining challenges to financial stability that could be addressed with better regulation and market infrastructure.

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G21 Banks; Depository Institutions; Micro Finance Institutions; Mortgages

G28 Financial Institutions and Services: Government Policy and Regulation

R31 Housing Supply and Markets