Financial Crises: Why They Occur and What to Do about Them

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- however, can do much better at *limiting* crises

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- What can be done *ex ante* to prevent/limit crises?

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- if some banks fail, credit market can get "stuck" - - no banks willing to lend

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  – induces potato growers in Slovakia to grow and sell *more*

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- Suppose puts cap on potato price or taxes “windfall” profits
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  – this creates potato shortage or black market in potatoes

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  - lend money to good ideas

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    $300 profit -- 200% return!

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  - highly leveraged bank may fail if loses bet or two

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    systemic risk

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  - not due to *panic*, but to *rational* responses by bankers and borrowers

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- solution: government imposes cap or fine on smoke emissions by steel plant

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- *ex ante*: to prevent crisis in *first* place

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  – constraints on what banks can do

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- Can certainly do a lot better than we’ve done this time