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Why the Crisis Worsened Dramatically a Year after it Began

FIGURE 12 SHOWS, using the same Libor-OIS measure of tension in the financial markets as in Figure 7, how dramatically the financial crisis worsened in October 2008. Recall that in our research paper on the subject, John Williams and I called the jump in spreads in August 2007 “A Black Swan in the Money Market.” The October 2008 events were even more unusual. Not only was the crisis prolonged for more than a year, but it worsened, according to this measure, by a factor of four. It became a serious credit crunch with large spillovers, seriously weakening an economy already suffering from the lingering impacts of the high oil price bout and the housing bust. Notice the close correlation in Figure 12 between our measure of counterparty risk and the Libor-OIS spread, demonstrating convincingly that all along the problems in the market were related to risk rather than to liquidity.

Many commentators have argued that the crisis worsened because the U.S. government (specifically the Treasury and the

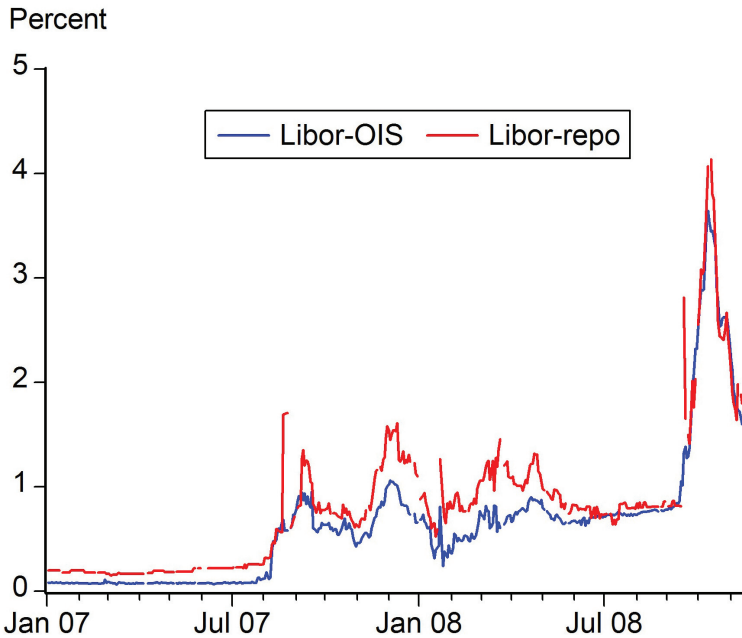


FIGURE 12. The Crisis Worsens

Federal Reserve) decided not to intervene to prevent the bankruptcy of Lehman Brothers over the weekend of September 13 and 14. It is difficult to bring a rigorous empirical analysis to this important question, but researchers must do so because future policy actions depend on the answer. Perhaps the best empirical analyses we can hope for at this time are event studies that look carefully at reactions in the financial markets to various decisions and events. Such an event study, summarized below, suggests that the answer is more complicated than the decision not to intervene to prevent the Lehman bankruptcy and, in my view, lies elsewhere.

An Event Study

Figure 13 focuses on a few key events from September 1 through mid October—the last few observations in Figure 12. Since mid October a host of new policy interventions have taken place—including implementation of the Troubled Asset Relief Program (TARP), guarantees by the Federal Deposit Insurance Corporation (FDIC), Federal Reserve support for the commercial paper market, similar actions in other countries—and conditions have improved somewhat, as seen in the graph.

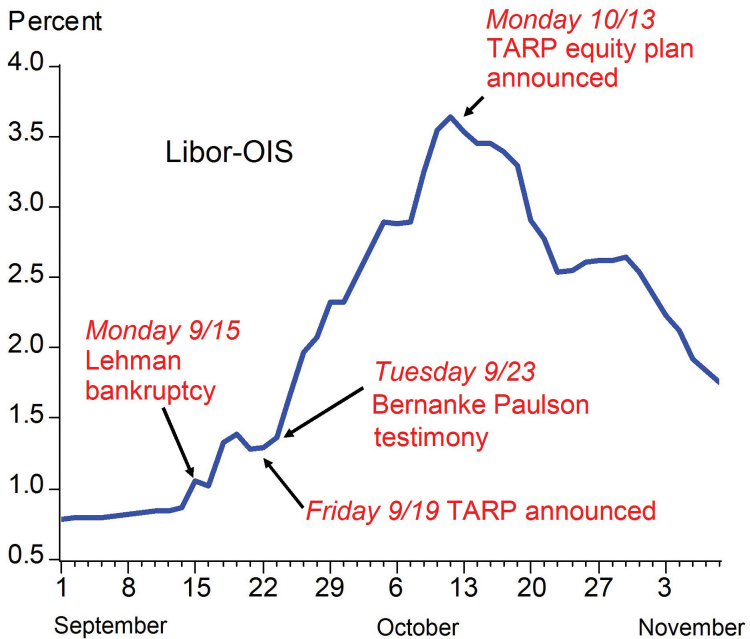


FIGURE 13. Event Study of the Worsening Crisis (2008)