KEY CONCEPTS

assets
balance sheet
bank run
bankruptcy
capital
capital requirement
equity
global saving glut
insolvency
leverage
liabilities
liquidity crisis
net worth
reserve requirement
securitization
systemic risk

REVIEW QUESTIONS

1. By roughly how much did housing prices fall during the financial crisis? What about the stock market?
2. How severe was the Great Recession? What pieces of economic data would you cite to support your answer?
3. What is a balance sheet? What is net worth?
4. What is leverage, and why is it so important in understanding the financial crisis?

EXERCISES

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1. **The latest data on the financial crisis:** Pick two figures from this chapter, and update them to include the latest available data. What does this tell you about how the economy has evolved in response to the financial crisis?
2. **The current state of the European economy:** By now, you are relatively familiar with recent economic events in the United States. But what about Europe? Write two paragraphs about the state of the economy in the Euro area over the past several years. What has happened to inflation, real GDP growth, and unemployment? What about a key policy interest rate set by the European Central Bank (ECB)? [*Hint*: The ECB sets several key interest rates, including a "deposit rate" (the interest rate the ECB pays on deposits from banks) and a "lending rate" (the interest rate it charges for overnight loans). All are useful and interesting. To keep us all on the same page, let's look at the lending rate.] An extremely helpful resource for this exercise is the ECB's Statistical Data Warehouse: http://sdw.ecb.europa.eu. (You may find it convenient to make a brief table of this data or even to copy some of the ECB's graphs.)
3. **Leverage in the financial system:** Choose two financial institutions and look up their balance sheets online. (For example, Yahoo! Finance provides these data in an easily accessible form at http://finance.yahoo.com/q/bs?s=GS.) What is the leverage ratio of the two companies you've chosen? For each $100 of assets, how much is financed with equity and how much with debt? By what percentage would assets have to decline in value to bankrupt these financial institutions?

4. **Systemic risk:** Consider the following balance sheets for two hypothetical financial institutions, bank B and bank C:

Bank B's Balance Sheet

Assets		Liabilities	
Cash	1,000	Deposits	1,400
Loan to bank C	500		
Total assets	???	*Total liabilities*	???
		Equity (net worth)	???

Bank C's Balance Sheet

Assets		Liabilities	
Mortgage-backed securities	800	Deposits	200
		Loan from bank B	500
Total assets	???	*Total liabilities*	???
		Equity (net worth)	???

(a) Fill in the missing entries in the balance sheets (denoted ???).
(b) What is the leverage ratio in each bank?
(c) Suppose housing prices fall sharply and the mortgage-backed securities held by bank C fall in value to only $500. What happens to bank C's net worth?
(d) The shortfall in bank C's equity means that it cannot repay the loan it received from bank B. Assume bank C pays back as much as it can, while still making good on its deposits. What happens to the net worth of bank B?
(e) Discuss briefly how this is related to systemic risk.