Not (Yet) a Minsky Moment

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What Happened?

- Subprime credit collapse
- MBS => CDO => LSS => ABCP
- ABCP and SIVs => Banks, MMMF
- Libor elevated (adverse selection costs)
- Collapse of confidence in securitization
  - Ratings agencies underestimated risks
  - Agency problems of brokers, banks, ratings

Figure 1: Annual Cash CDO Issuance

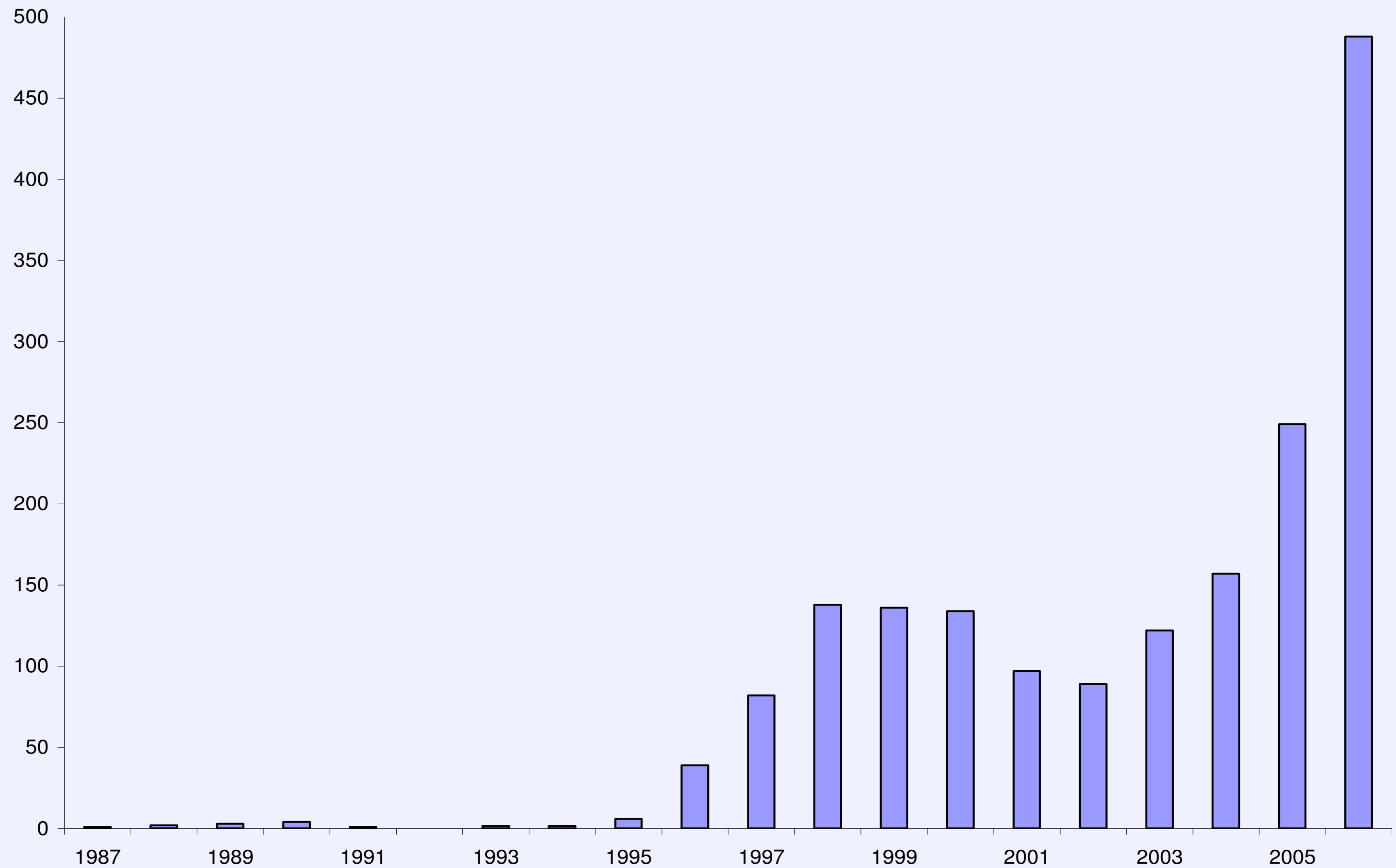
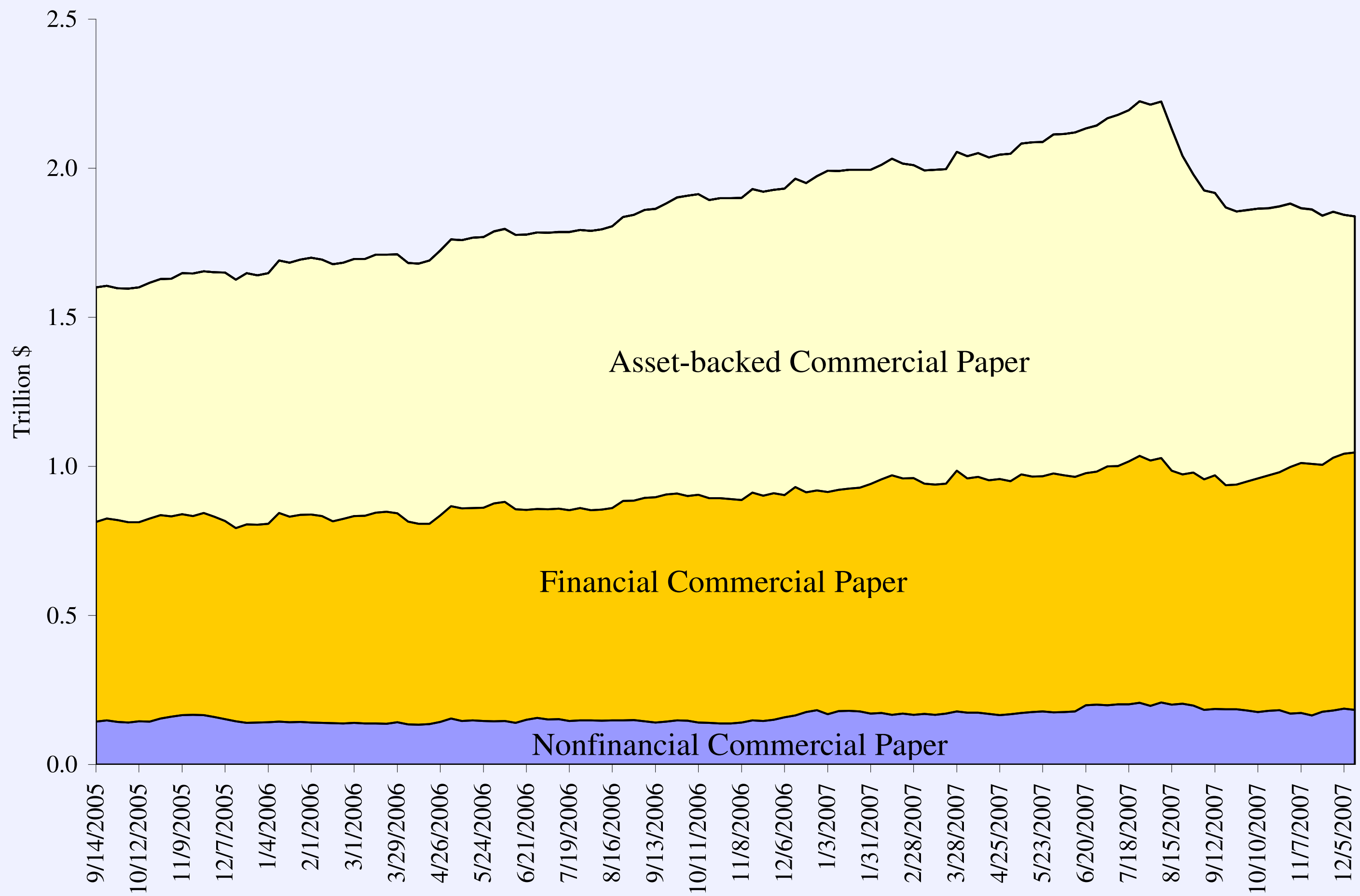
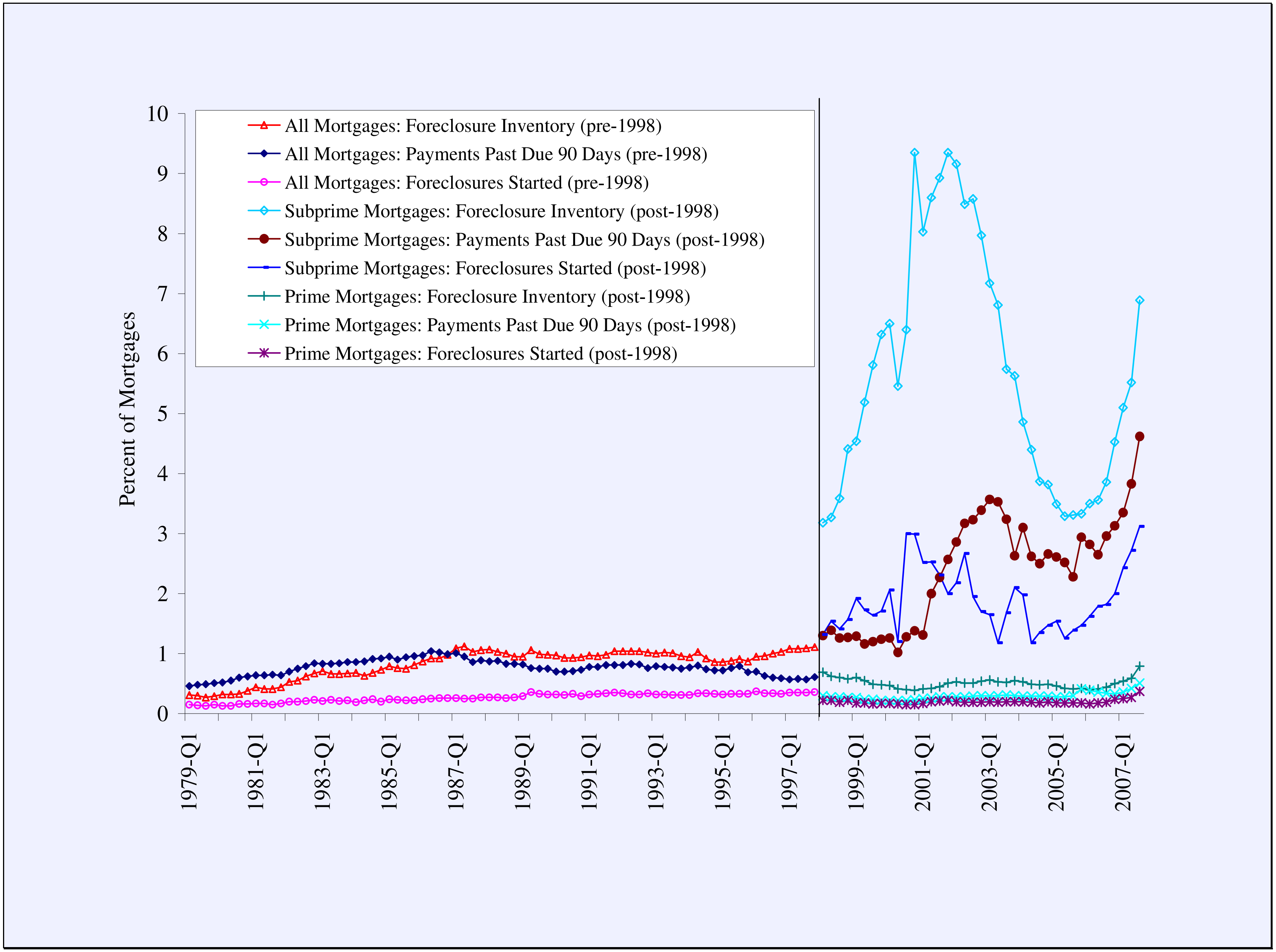


Figure 9: Commercial Paper Outstanding (Weekly, Seasonally Adjusted)



Why did this happen?

- Peak of subprime foreclosure rate, by some measures, was four years ago! Why did issuance and use in securitization accelerate?
- Losses then were small, owing to rapidly rising home prices, and ratings agencies built optimistic LGD into scenarios. That was idiotic, and produced a doubling of originations of subprime from 2003 to 2005.
- Novelty of CDOs, LSSs, SIVs, combined with grade inflation by ratings agencies (what does BBB mean?) likely produced confusion about true risk.
- High liquidity and low yields, along with a long period without turmoil encouraged search for high yields and underestimation of risk.
- This sort of myopia is, indeed, Minskyesque! But a true Minsky moment is more – a financial crisis that produces a severe macro decline. Will this happen?



All Mortgages: Foreclosure Inventory (pre-1998)
All Mortgages: Payments Past Due 90 Days (pre-1998)
All Mortgages: Foreclosures Started (pre-1998)
Subprime Mortgages: Foreclosure Inventory (post-1998)
Subprime Mortgages: Payments Past Due 90 Days (post-1998)
Subprime Mortgages: Foreclosures Started (post-1998)
Prime Mortgages: Foreclosure Inventory (post-1998)
Prime Mortgages: Payments Past Due 90 Days (post-1998)
Prime Mortgages: Foreclosures Started (post-1998)
Percent of Mortgages
10
9
8
7
6
5
4
3
2
1
0
1979-Q1
1981-Q1
1983-Q1
1985-Q1
1987-Q1
1989-Q1
1991-Q1
1993-Q1
1995-Q1
1997-Q1
1999-Q1
2001-Q1
2003-Q1
2005-Q1
2007-Q1

Macroeconomic Consequences?

- Financial system and credit supply
  - Banks and others must absorb losses, reintermediate lending, raise capital to expand capacity to grow, as needed; if the capacity of banks to supply credit, and the capacity of firms to raise credit directly, is inadequate, then it is possible to experience a severe credit crunch like 1989-91.
  - Elevated Libor spreads mean that monetary policy must lower Fed funds more than it would otherwise have to, in order to keep market interest rates from rising.
- Housing prices
  - If housing was in a bubble that just burst, prices could fall dramatically; any collapse in credit affecting housing and/or consumers could aggravate that decline.
- Economic activity
  - The combination of a credit crunch, and the wealth effects of housing price declines on consumption, could tip us into a recession.

Financial System and Credit Supply

- This is not 1989-91.
  - Banking system condition is good (losses will likely amount to two missing quarters of earnings in the worst case, which is Citi).
  - Large losses are being recognized quickly, and loans are being reintermediated quickly (banks are absorbing securitizations on the balance sheet).
  - Liquidity risks of ABCP and SIVs are now reasonably contained for US banks.
  - Banks are much better diversified (due to deregulation), and shocks are not as concentrated in banks this time.
  - Banks are not having trouble raising tier 1 capital (predictably in the form of preferred).
  - Fed is responding aggressively to Libor spread problem.
  - Corporate balance sheets are strong (dividend tax cut) and there is lots of financial slack and corporate liquidity.

Figure 18: Commercial and Industrial Loans

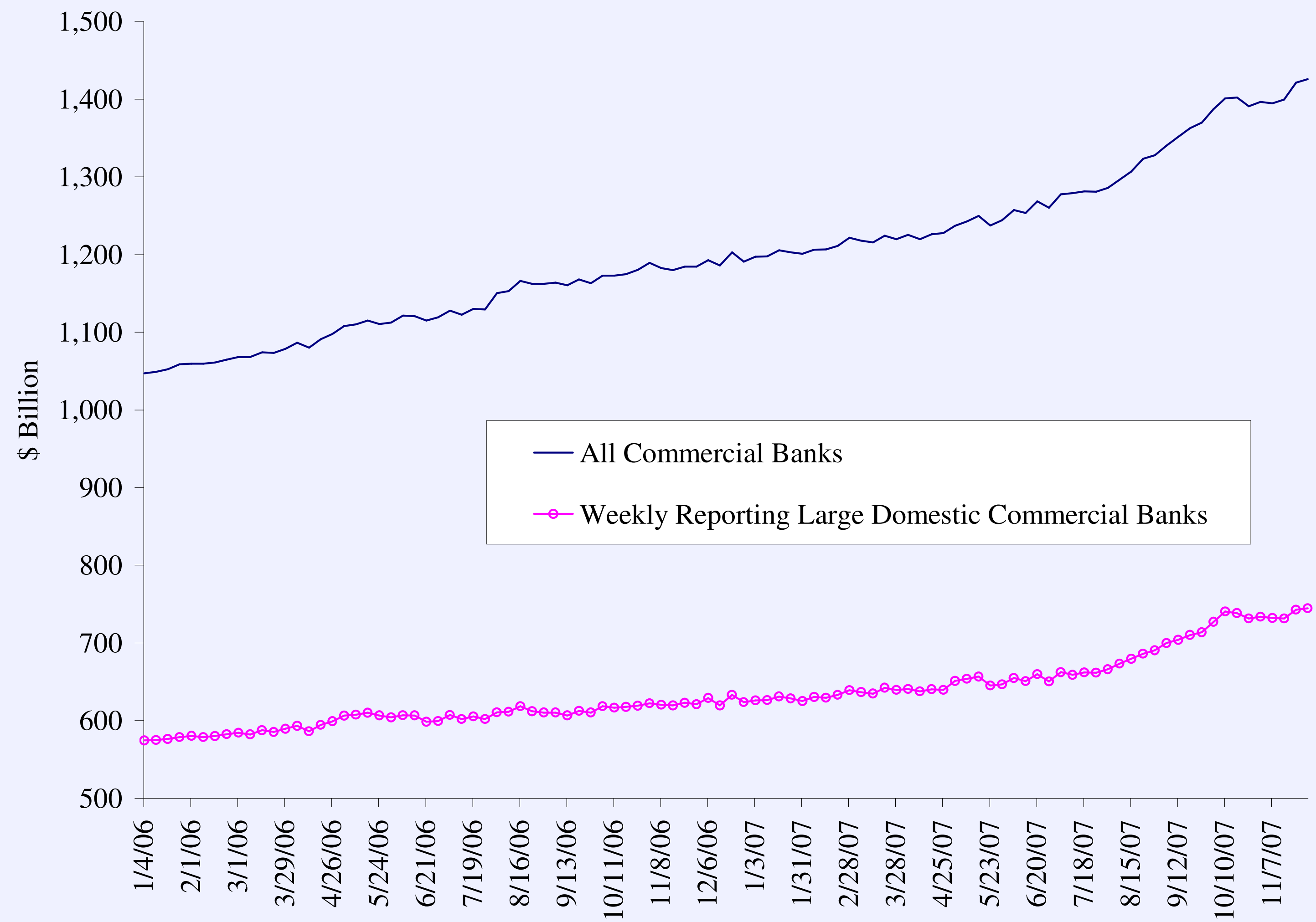


Figure 10: Commercial Paper Rates, LIBOR, and Mortgage Rates

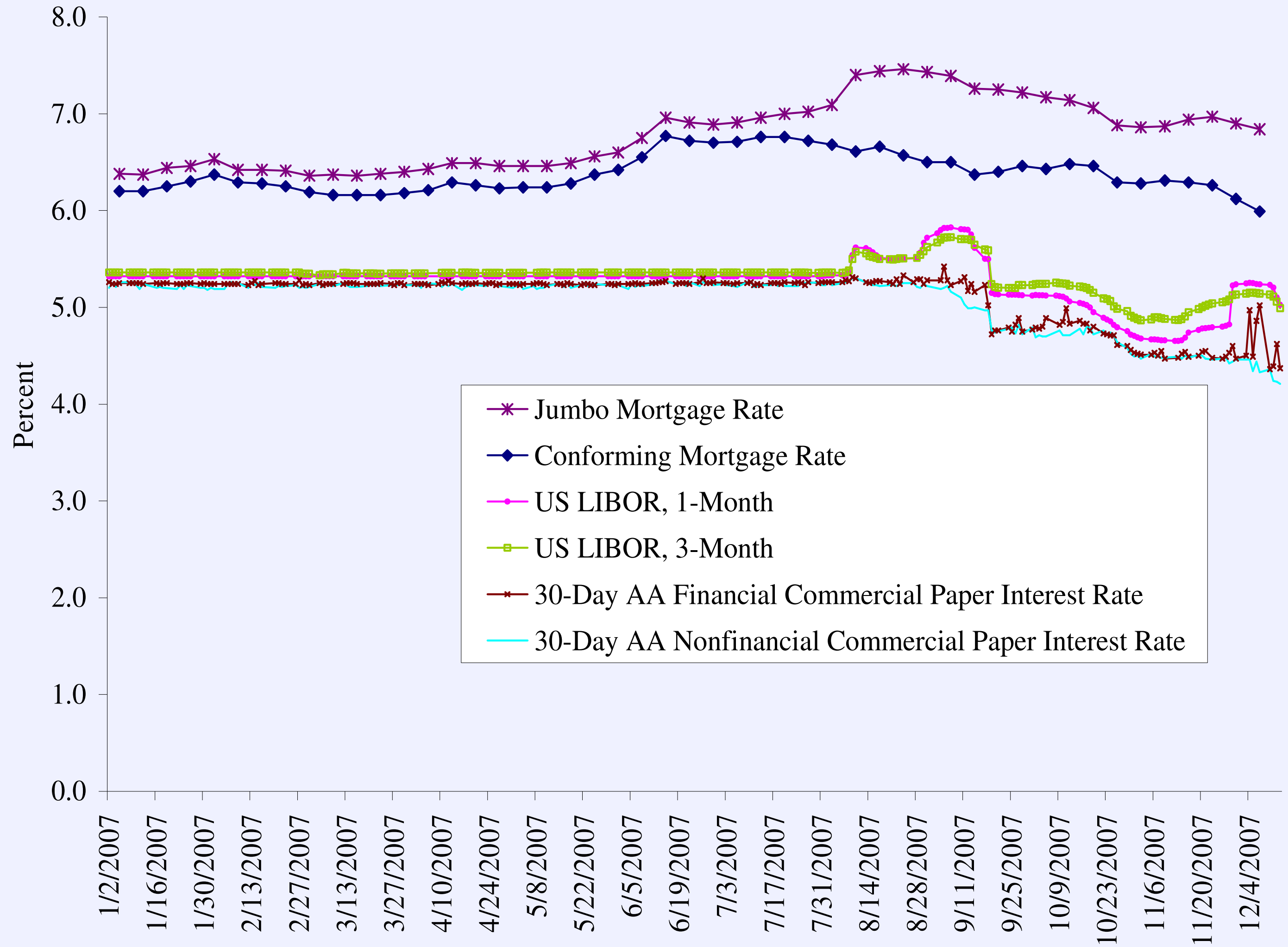


Figure 12: LIBOR, Treasury Bill, and Fed Funds Rates

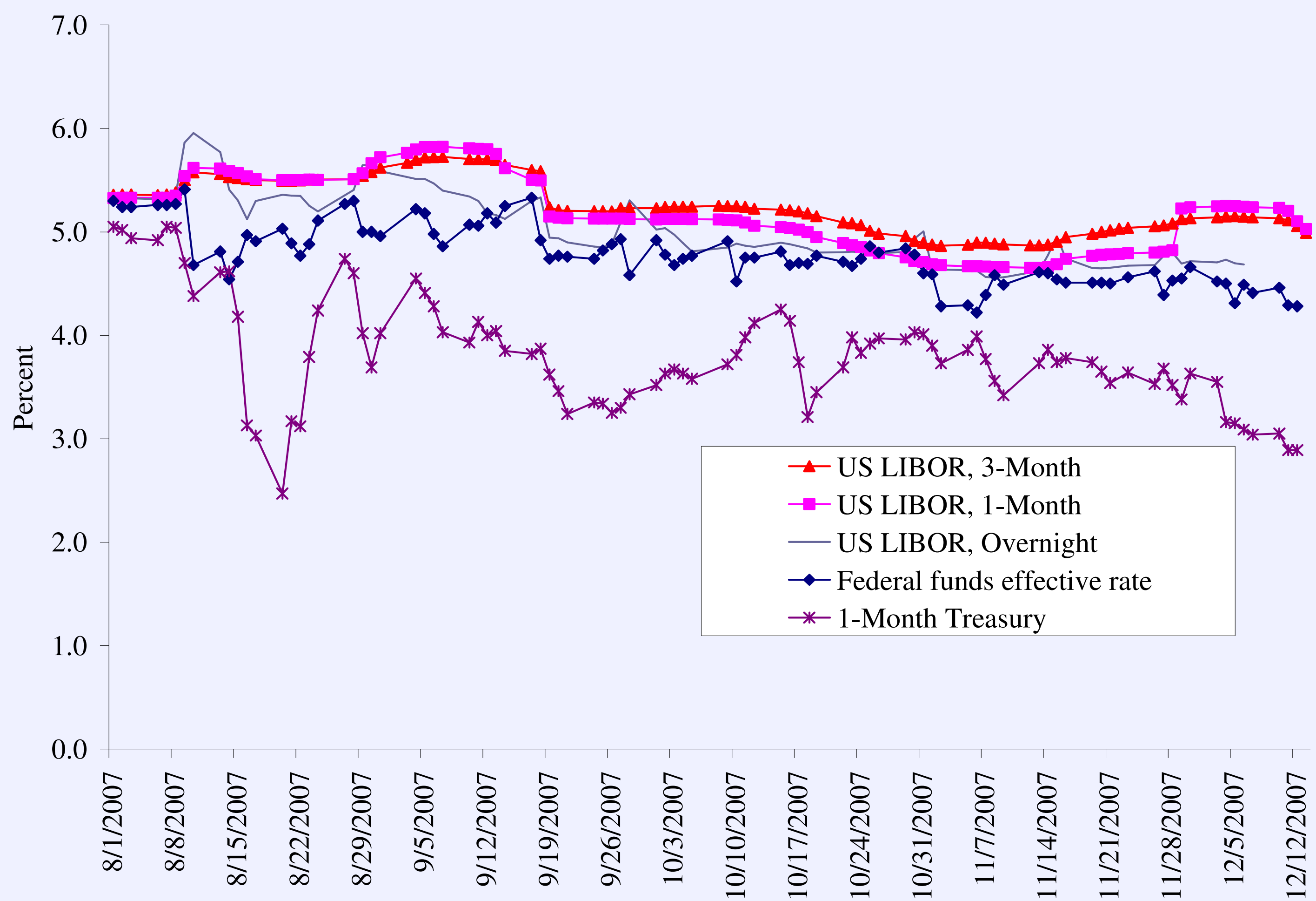
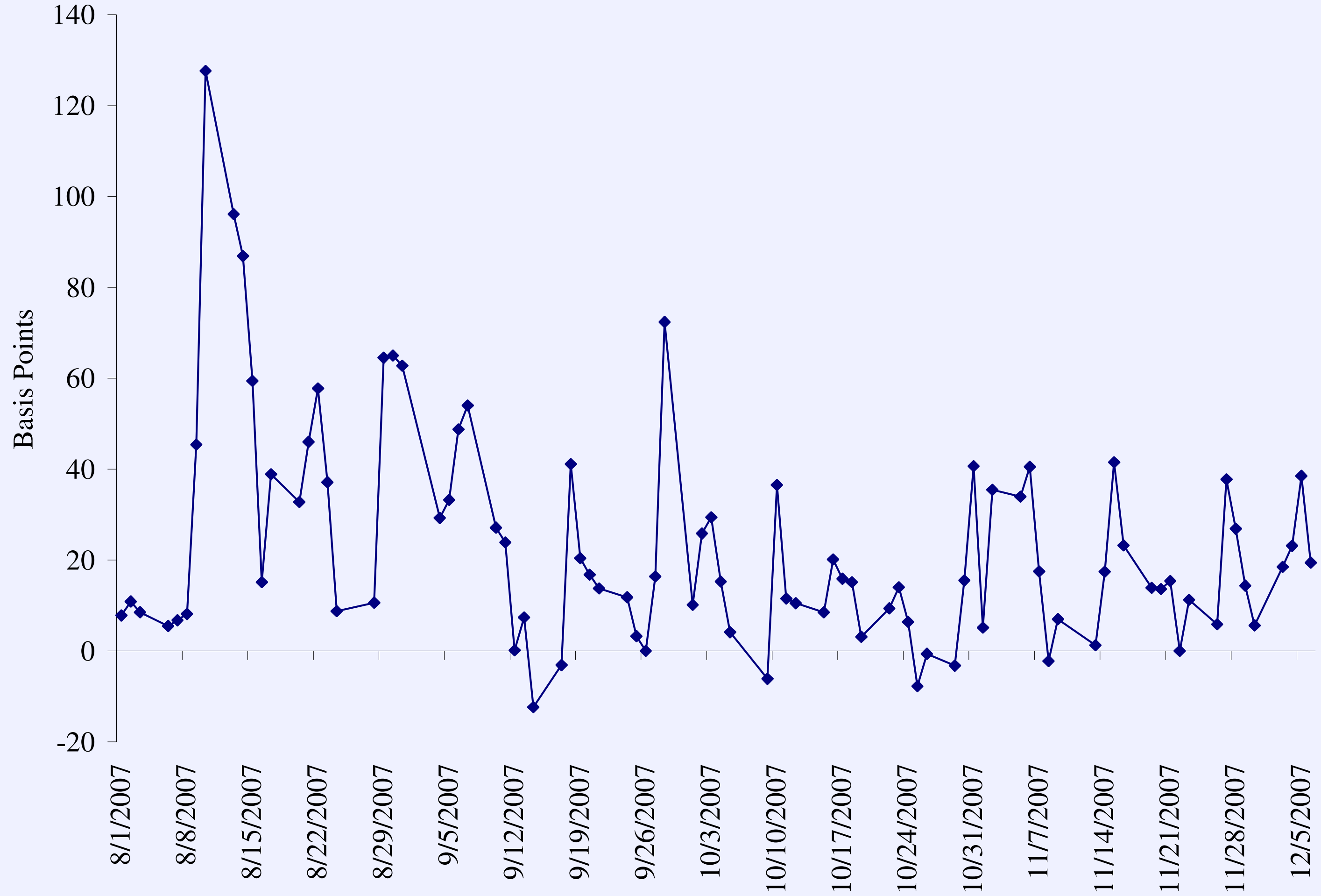


Figure 13: Overnight Libor-Fed Funds Spread



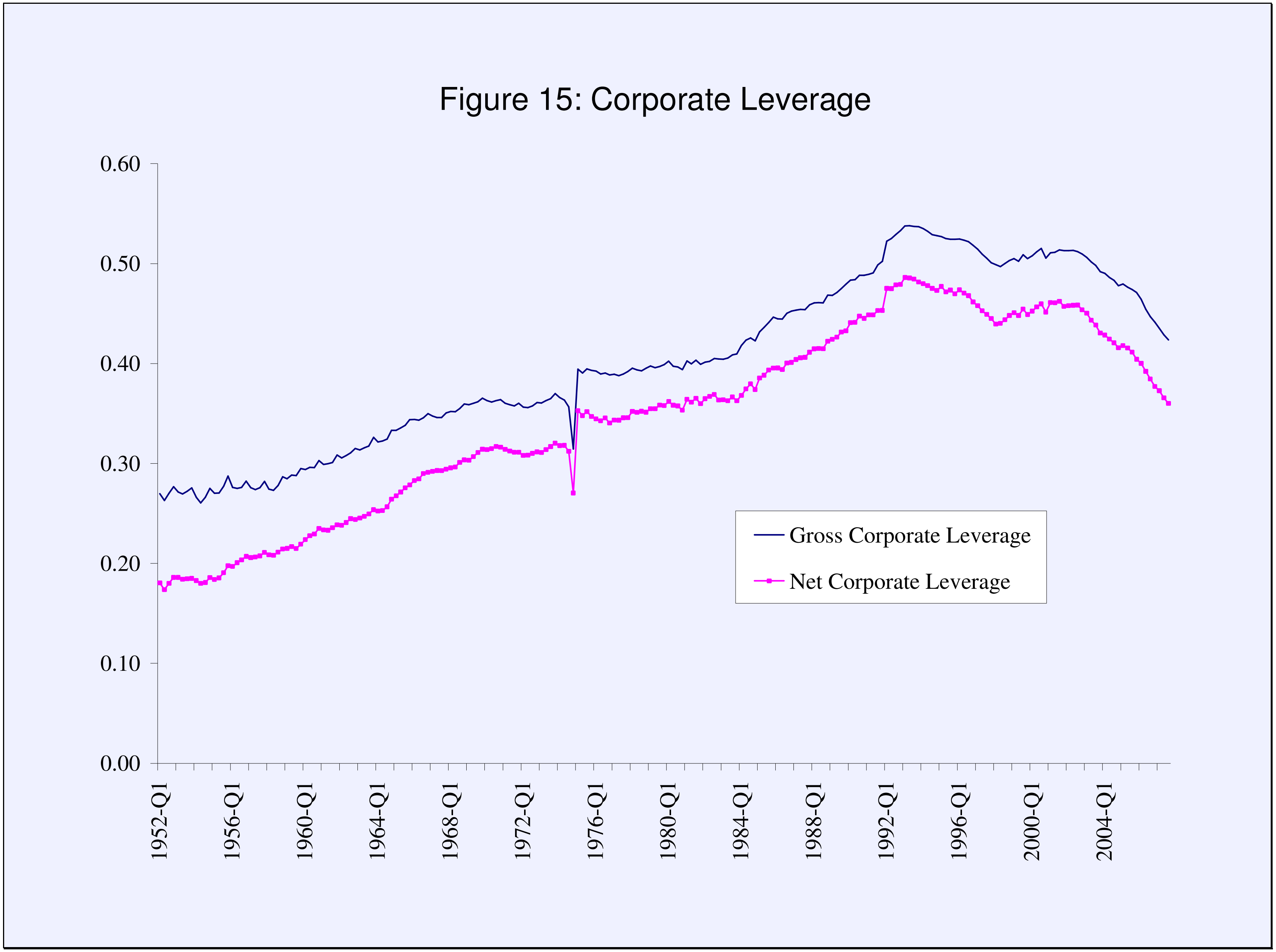


Figure 15: Corporate Leverage
0.60
0.50
0.40
0.30
0.20
0.10
0.00
1952-Q1
1956-Q1
1960-Q1
1964-Q1
1968-Q1
1972-Q1
1976-Q1
1980-Q1
1984-Q1
1988-Q1
1992-Q1
1996-Q1
2000-Q1
2004-Q1
Gross Corporate Leverage
Net Corporate Leverage

Housing Prices

- Perceptions are based on flawed data (median sales prices, or Case-Shiller index)
- There was no national housing bubble. The bubble was confined to a few locations, which are now troubled (Florida, Arizona, Nevada, parts of California). Other troubled spots have been in secular housing decline (Ohio and Michigan).
- Housing sales are way down, but this is true even in persistently booming markets (Seattle and Austin), and reflects a pause in buying, I believe, for the dust to settle. In the Spring, sales are likely to grow. There is no existing evidence in the literature of strong predictive content of sales for prices.
- Housing has already been in a recession for a year.
  - This has reduced starts, which going forward will provide some support for housing prices.

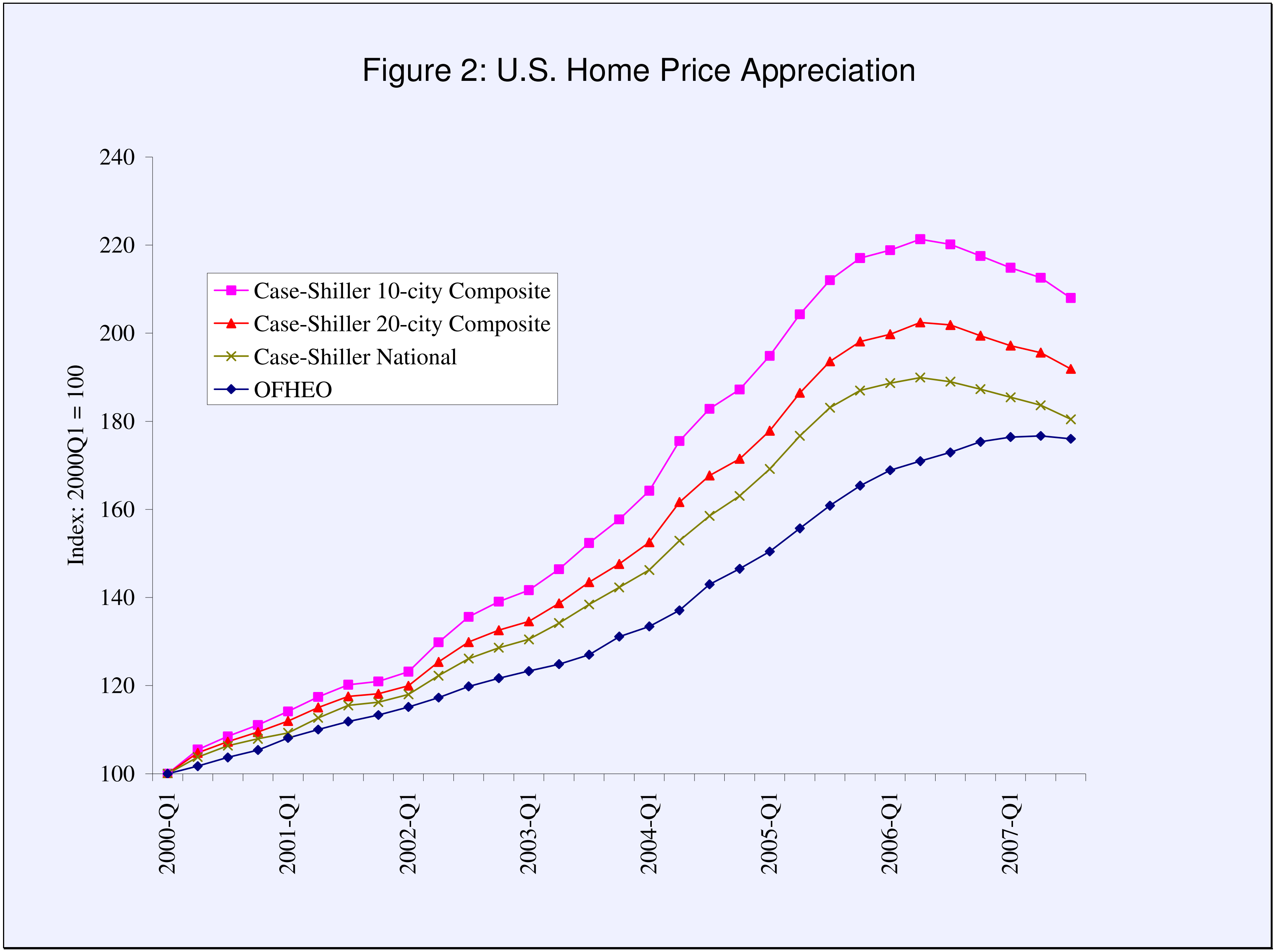


Figure 2: U.S. Home Price Appreciation
Case-Shiller 10-city Composite
Case-Shiller 20-city Composite
Case-Shiller National
OFHEO
Index: 2000Q1 = 100
240
220
200
180
160
140
120
100
2000-Q1
2001-Q1
2002-Q1
2003-Q1
2004-Q1
2005-Q1
2006-Q1
2007-Q1

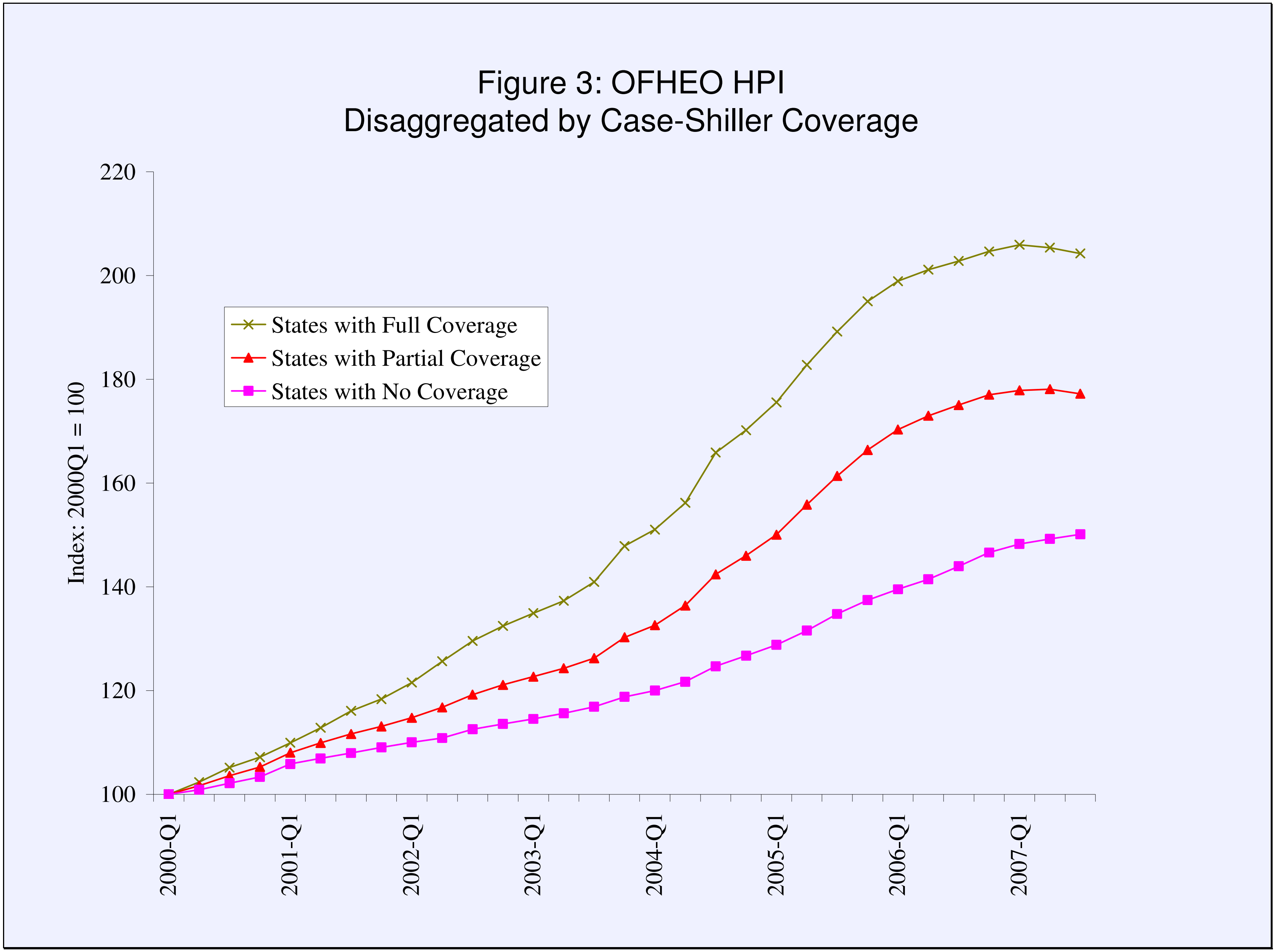


Figure 3: OFHEO HPI
Disaggregated by Case-Shiller Coverage
States with Full Coverage
States with Partial Coverage
States with No Coverage
Index: 2000Q1 = 100
220
200
180
160
140
120
100
2000-Q1
2001-Q1
2002-Q1
2003-Q1
2004-Q1
2005-Q1
2006-Q1
2007-Q1

Figure 5: State-Level Annual Home Price Appreciation (OFHEO) vs. State-Level Changes in Foreclosure Inventory Rates

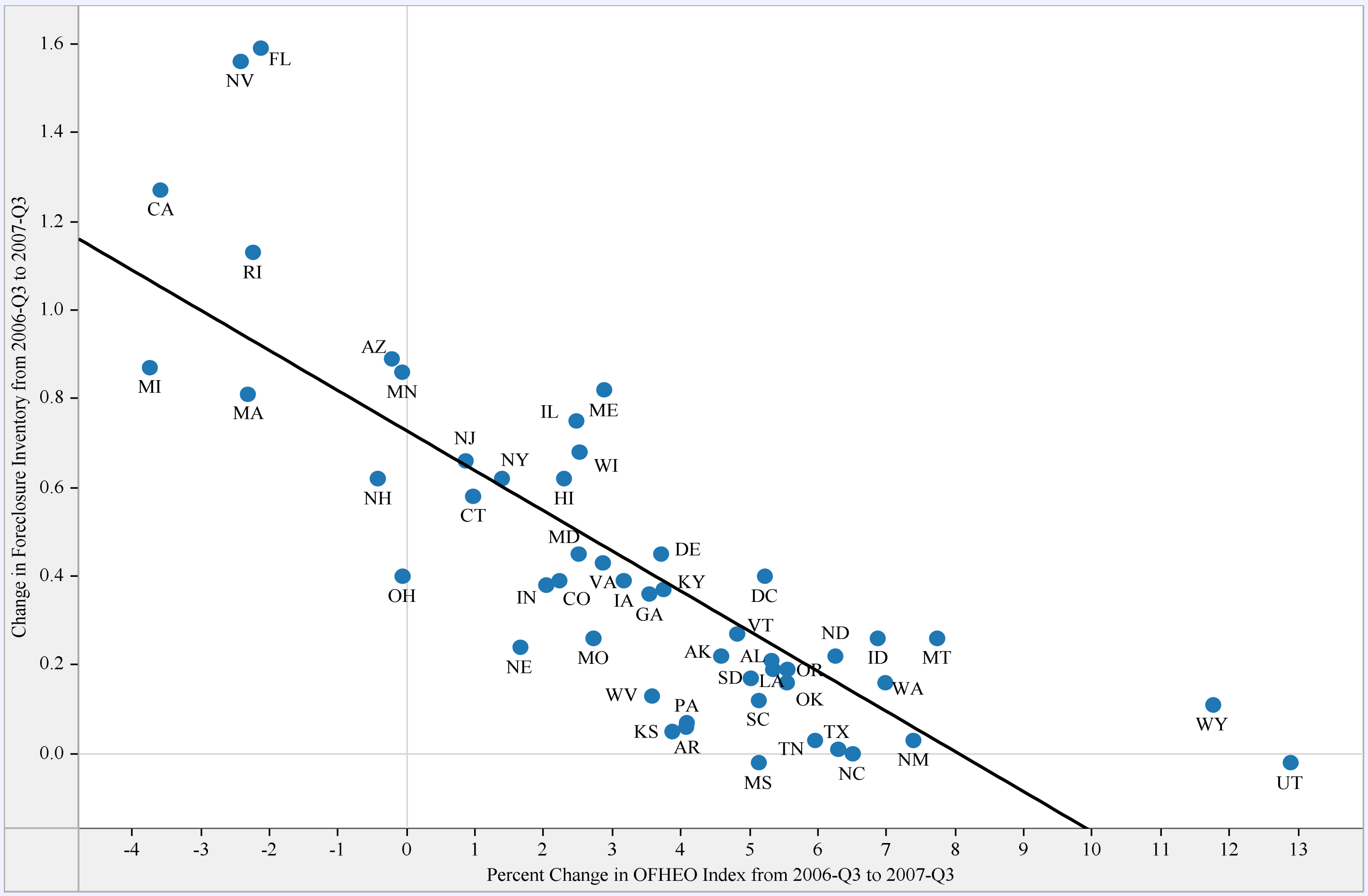


Figure 16: Real Household Net Worth Per Capita

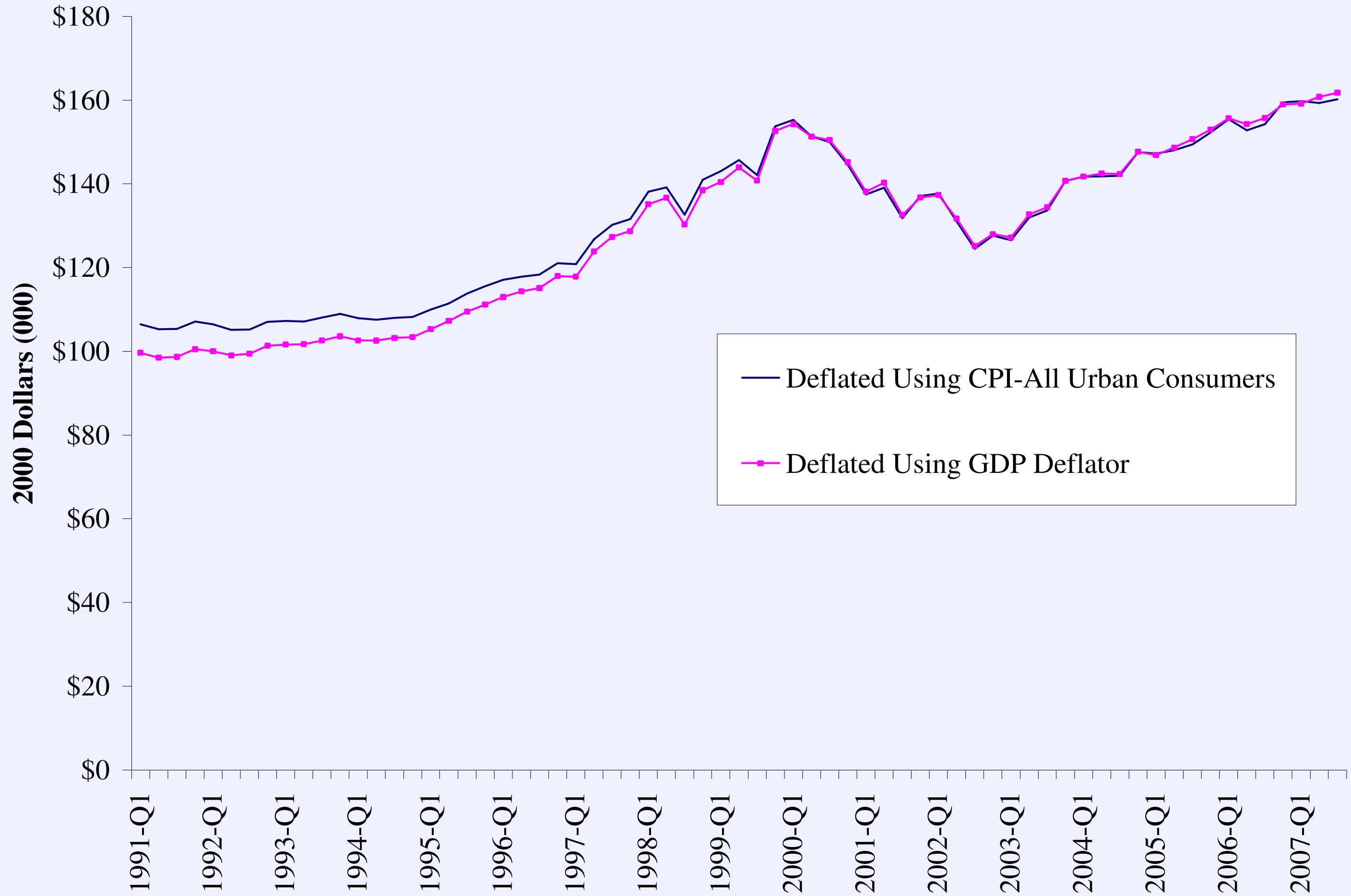
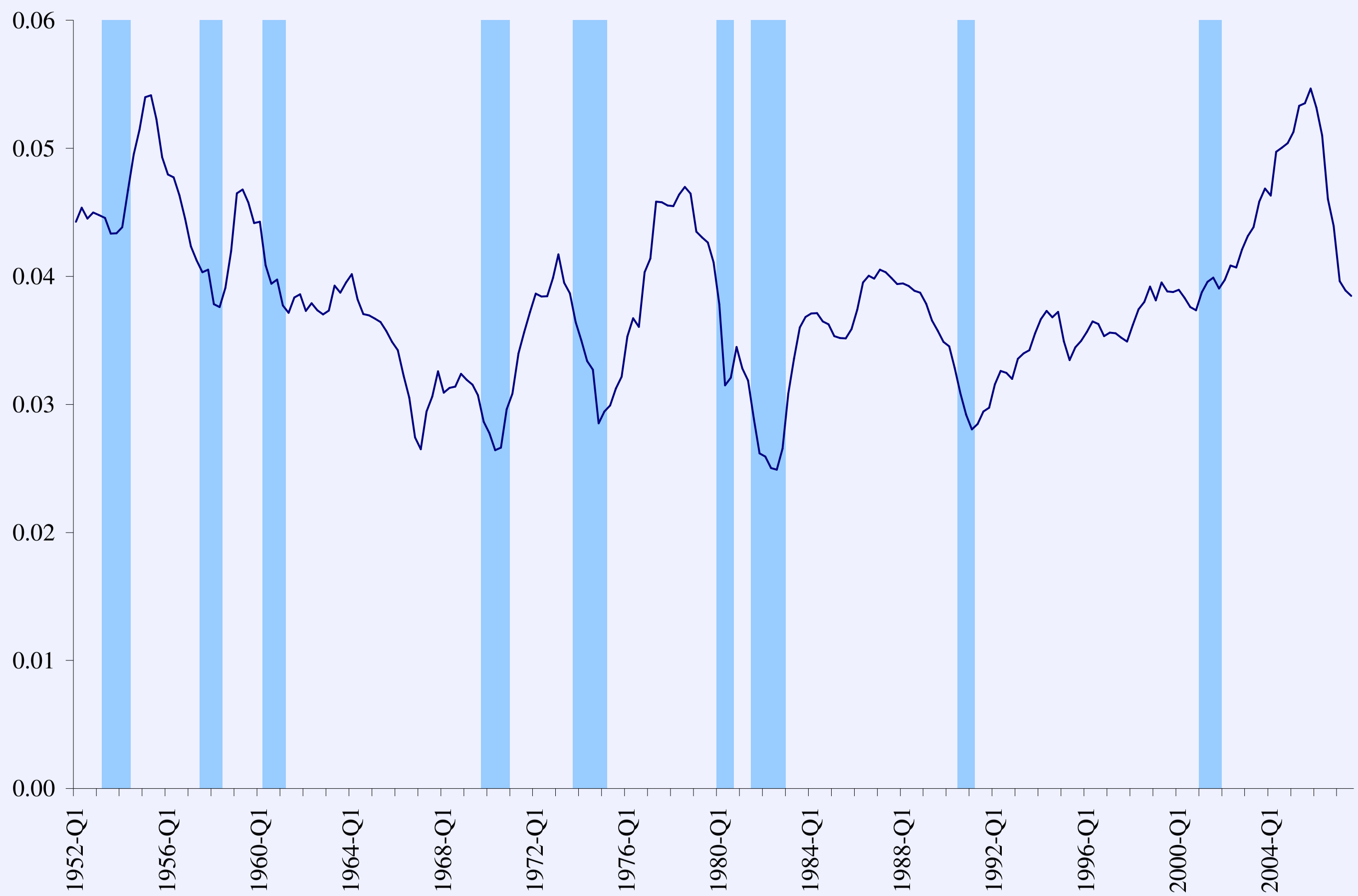


Figure 8: Residential Investment by Household Sector Relative to GDP



Recession Risk Minimal

- Credit crunch will not be severe.
- Credit spreads are elevated, but were too low before the turmoil.
- Housing prices will not decline very much, and declines will be concentrated in some regions.
- Housing wealth effects probably have been overestimated by the Fed (2%, not 5% elasticity – see Gan)
- Jobs, wages, IP, global growth continue to be positive factors looking forward.

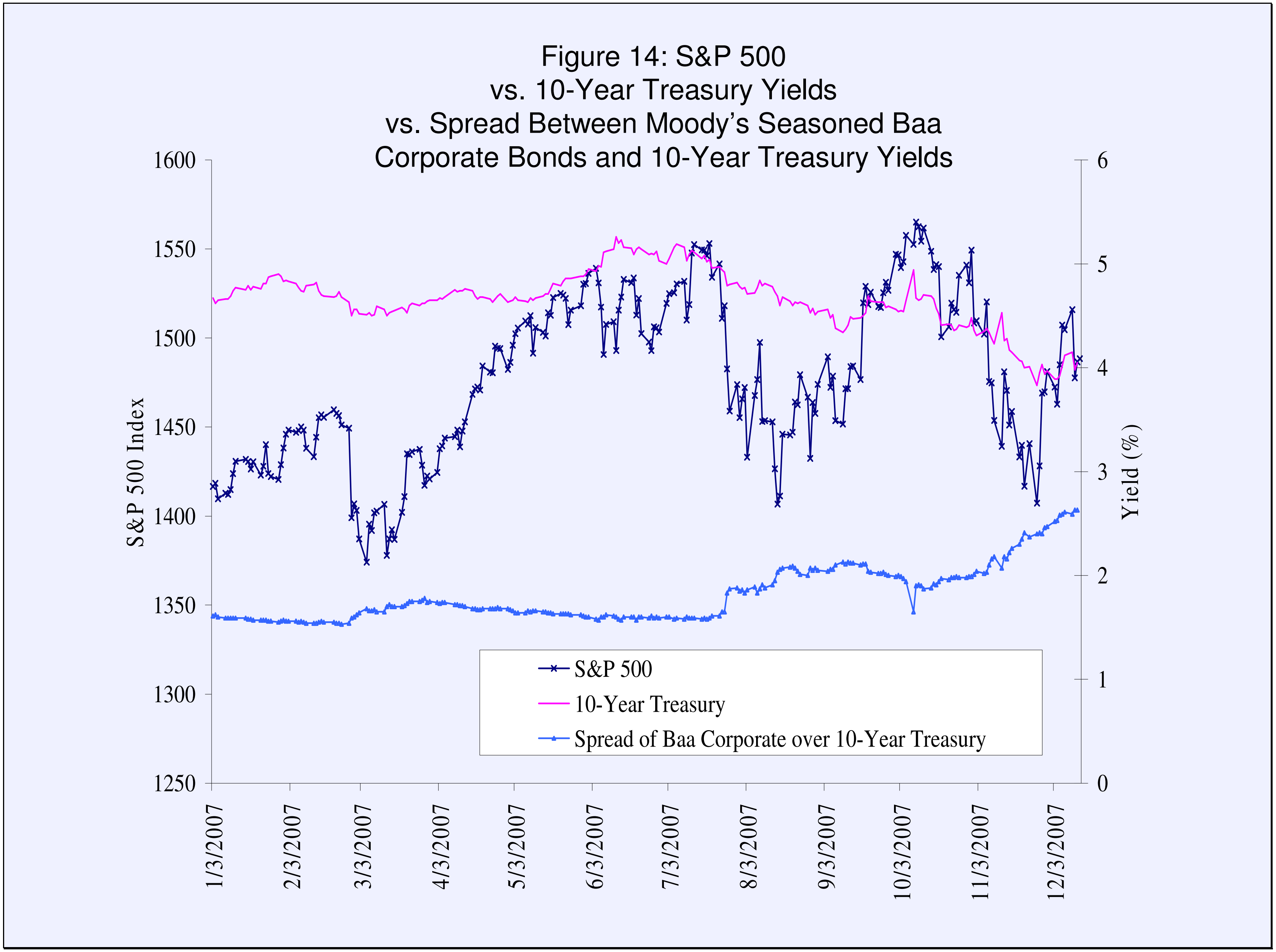


Figure 14: S&P 500
vs. 10-Year Treasury Yields
vs. Spread Between Moody's Seasoned Baa
Corporate Bonds and 10-Year Treasury Yields
S&P 500 Index
Yield (%)
1600
1550
1500
1450
1400
1350
1300
1250
6
5
4
3
2
1
0
1/3/2007
2/3/2007
3/3/2007
4/3/2007
5/3/2007
6/3/2007
7/3/2007
8/3/2007
9/3/2007
10/3/2007
11/3/2007
12/3/2007
S&P 500
10-Year Treasury
Spread of Baa Corporate over 10-Year Treasury

Policy Responses

- **Fed policy response** has been aggressive, perhaps appropriately; at this point is the same as 1970, 1987, and 1998 responses. New auction idea seems unnecessary.
- **M-LEC** was a bad idea (phony books, postponement of losses contribute to prolonged shocks and high adverse selection costs).
- **Foreclosure relief proposal:** Lots of downside, best understood as political front-running (questionable effectiveness, moral hazard, fairness questions, effects on investors going forward).
- **Better approach to refief** (long-term and short-term): Stop subsidizing imprudent leveraging; assist homeowners with downpayment matching grants.
- **Bank regulatory response**: Reform Basel II to (a) get rid of reliance on ratings (at least letter grades), (b) incorporate real market discipline rather than ratings and models, (c) require additional simple leverage limit, as in US (North Rock failure would have probably been avoided), (d) require prompt corrective action, and (e) FDICIA reforms of lending and resolution of failed institutions.
- **Reform GSEs**: Fannie and Freddie losses are unacceptably high, and lack a resolution mechanism. FHLBs lending risk is high ($51 billion of Countrywide's $100 billion in assets), and creates possibility of asset stripping of FDIC.