

The Global Financial Crisis, 2007-2010: Origins, Responses, Prognosis

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Three questions

1. Why housing?
2. Why the crisis?
3. And then: What now?

Housing debt permitted ↑ consumption

Mismatched maturities and leverage

Slow growth and high unemployment

The big problem – no demand

- After 1980, the global supply of goods grew faster than wages in rich countries

Global growth relied increasingly on US growth



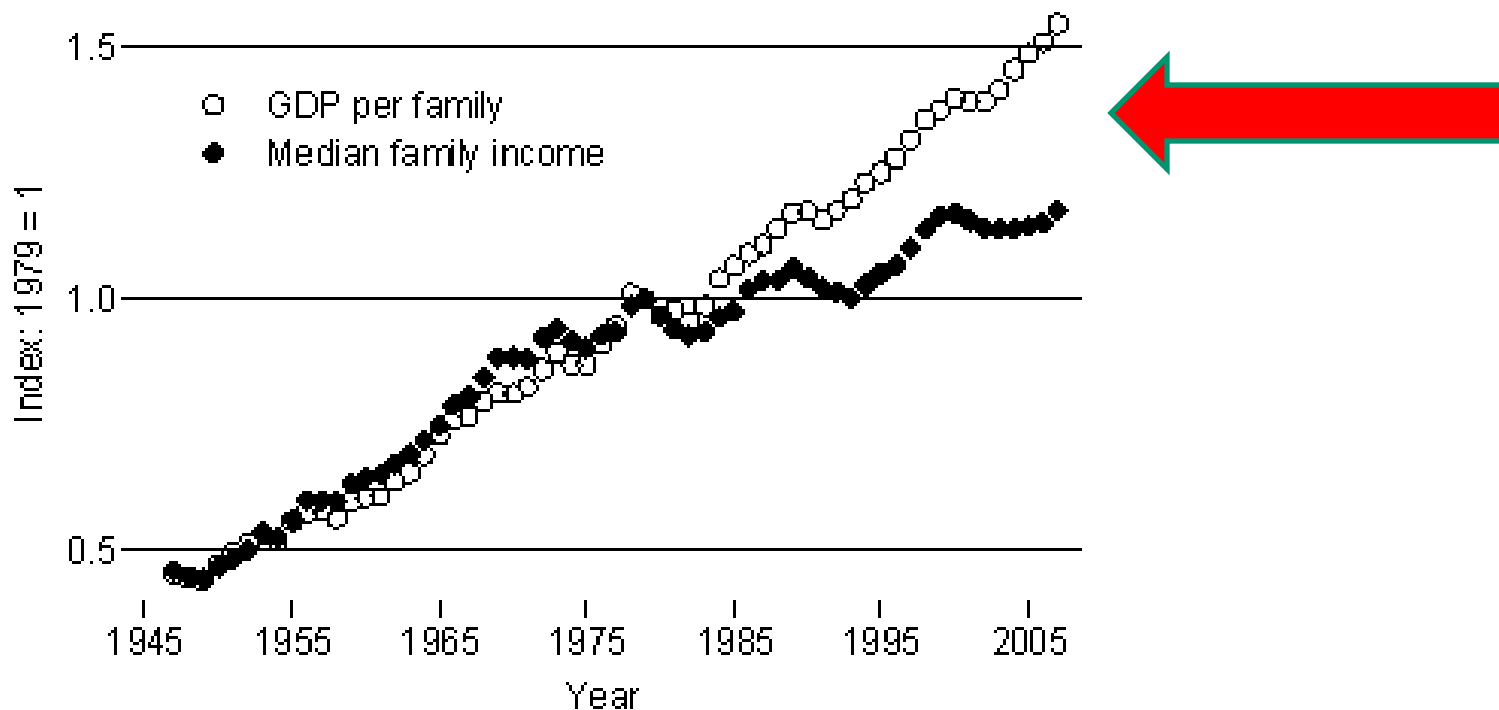
US growth increasingly relied on new debt



US housing debt made up most new debt

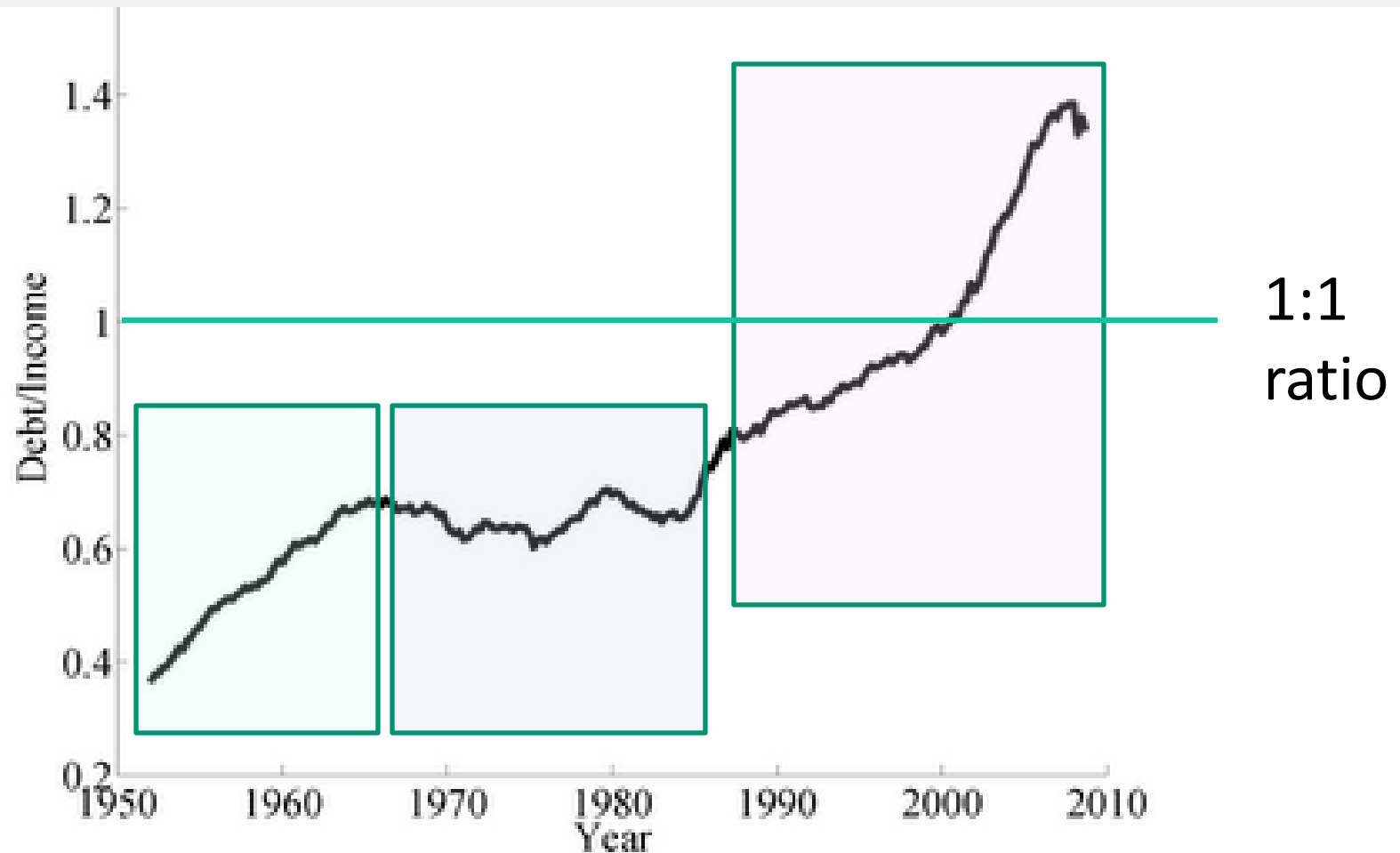
US family income vs GDP

Inequality rising: GDP per family and median family income, 1947-2007



Note: Inflation adjustment is via the CPI-U-RS. Median family income is posttransfer-pretax (posttax not available). Data sources: Census Bureau, www.census.gov/hhes/www/income/histinc/incfamdet.html; Bureau of Economic Analysis, www.bea.gov/national/nipaweb/Index.asp.

Rising US household debt compared to incomes



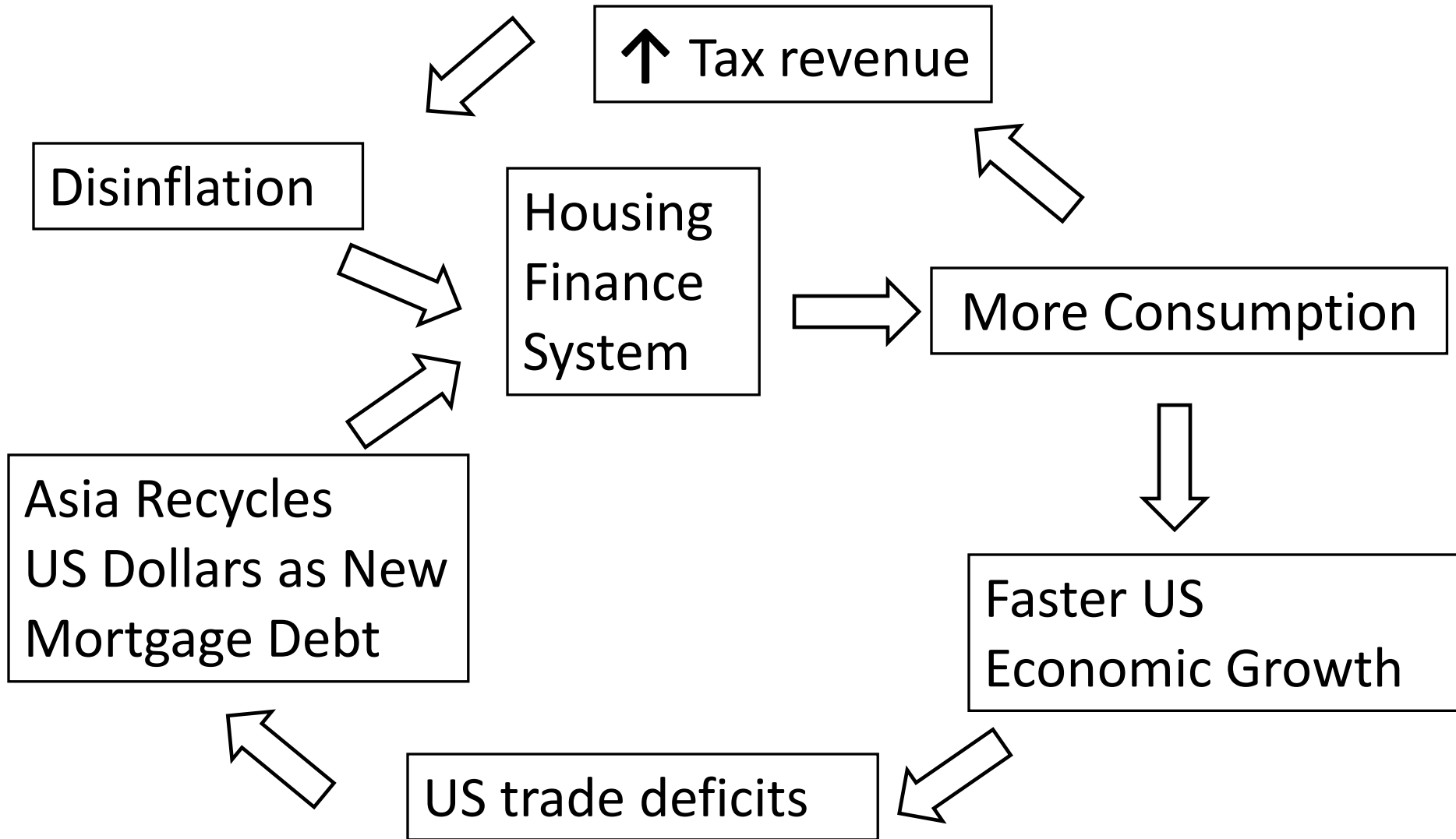
Why housing related debt?

- Single biggest asset for most Americans
- THUS: One – third of all US private securities are housing related (as mortgage backed securities)
- Housing finance system
 - makes it easy to renegotiate debt (to lower your mortgage interest rate and thus payments)
 - makes it easy to borrow more money when housing prices rise

corbis.

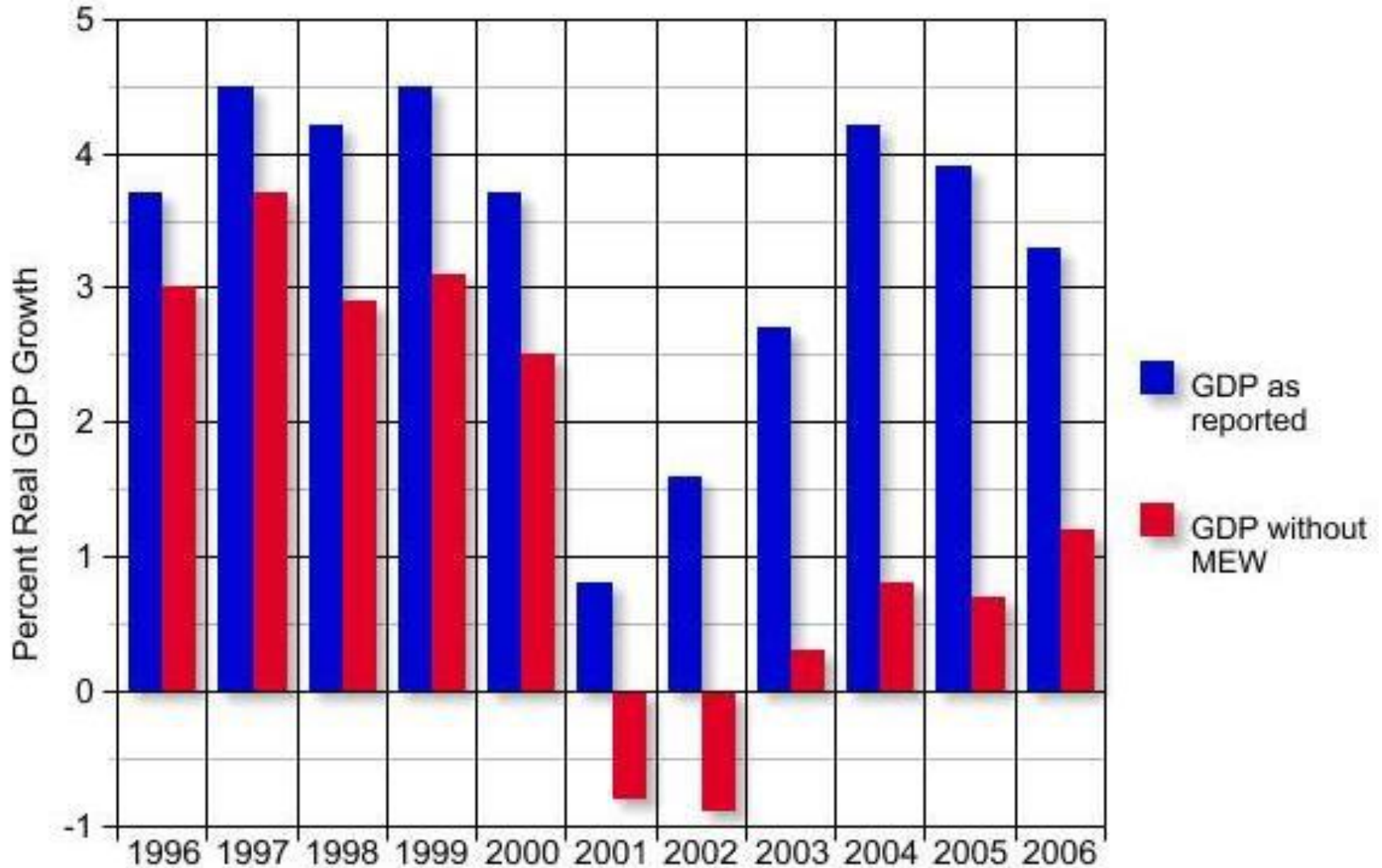


The 1990-2000s US growth cycle



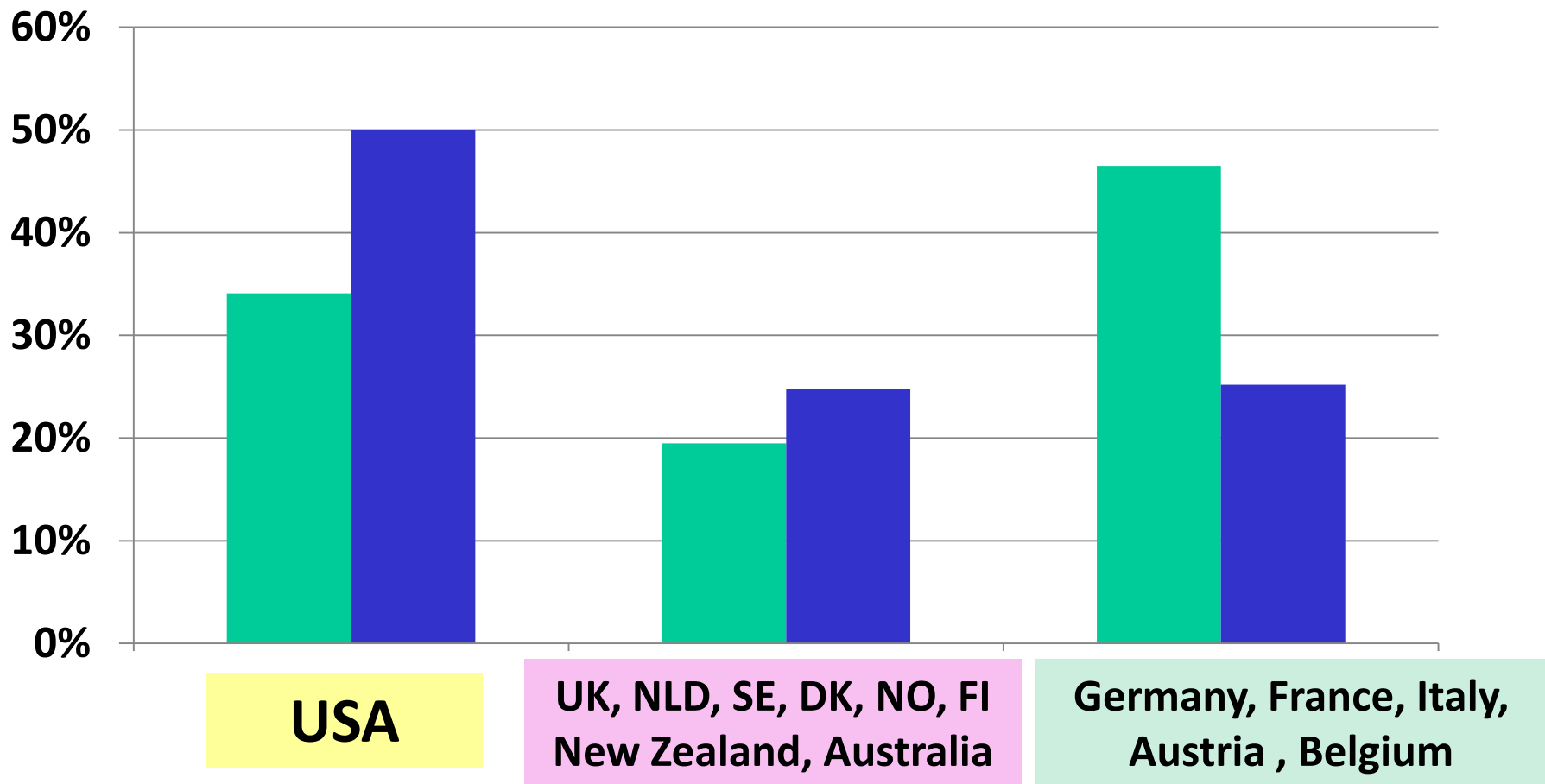
Mortgage equity withdrawal and growth

GDP Growth: With and Without Mortgage Equity Withdrawal



Employment gains, 1991-2005

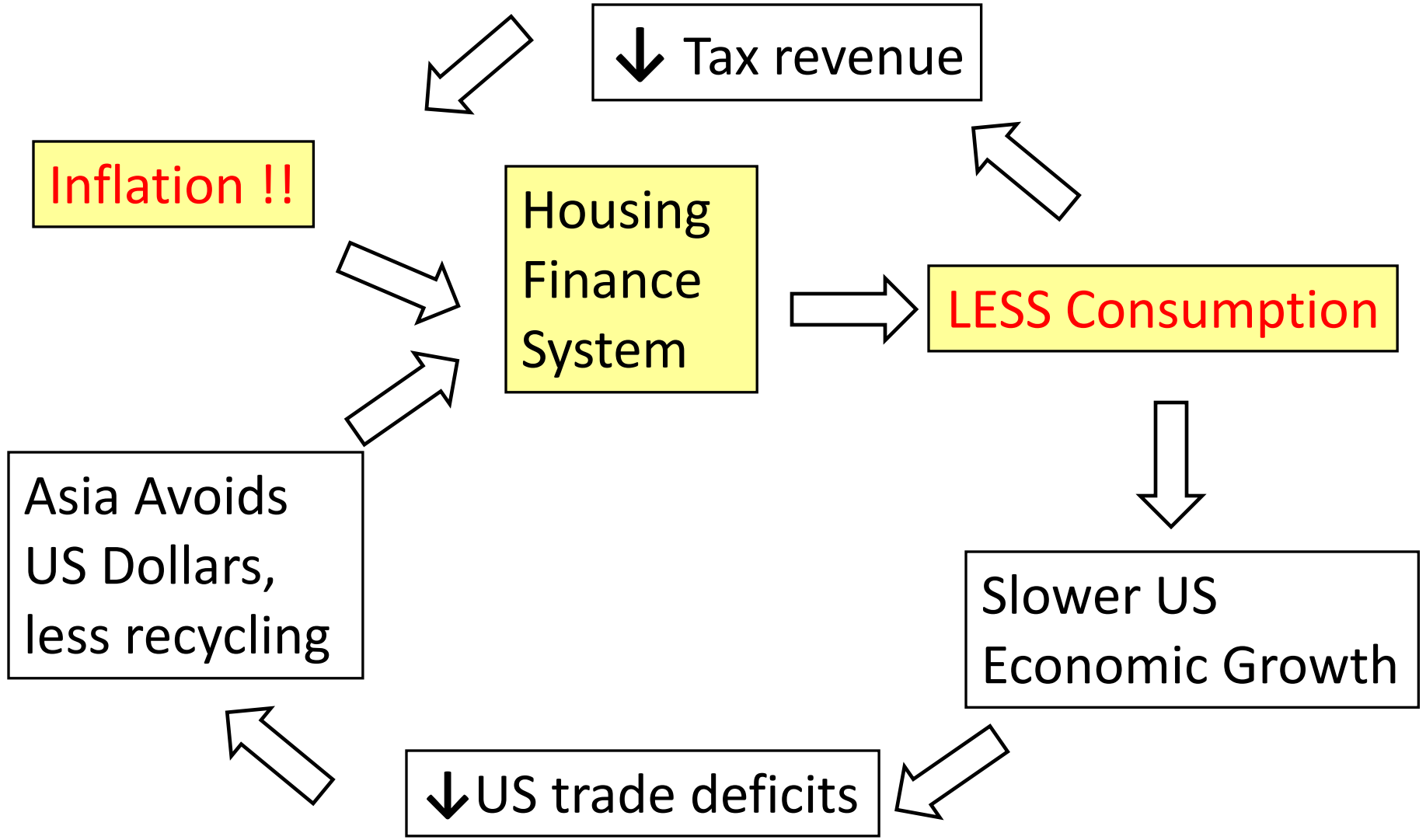
- Share of OECD Population, 2005, %
- Share of New Jobs, %



Weaknesses of this system

- **Maturity mismatches:** Borrowing short term to reinvest long term
 - ❖ By the US: from “poor world” => “rich world”
 - ❖ By US banks: from money markets => CDOs held by SIVs (and insured via CDSs)
 - ❖ By US households: using floating rate mortgages to fund current consumption...

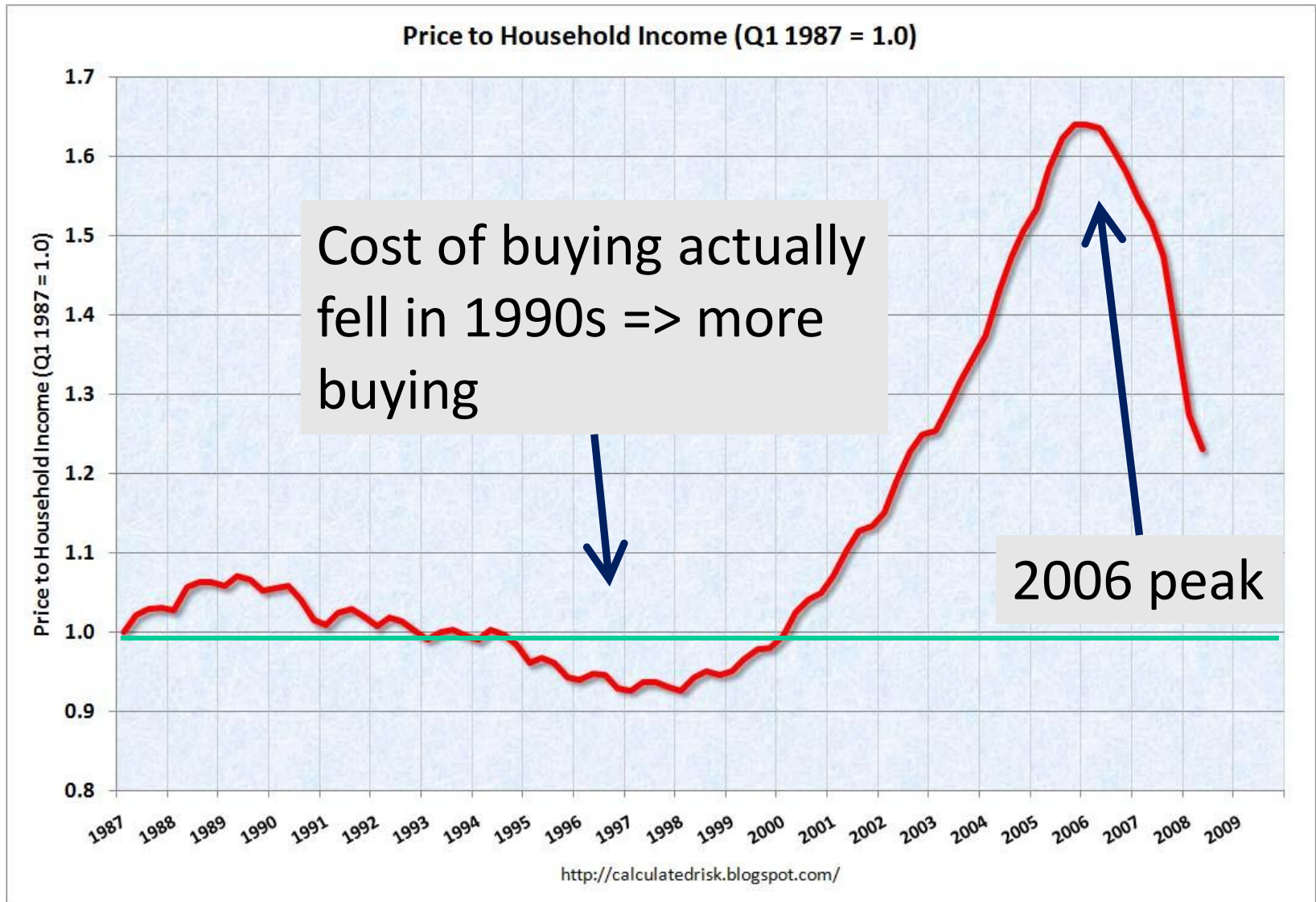
The 2006+ crisis cycle



Inflation rate, 3 year average

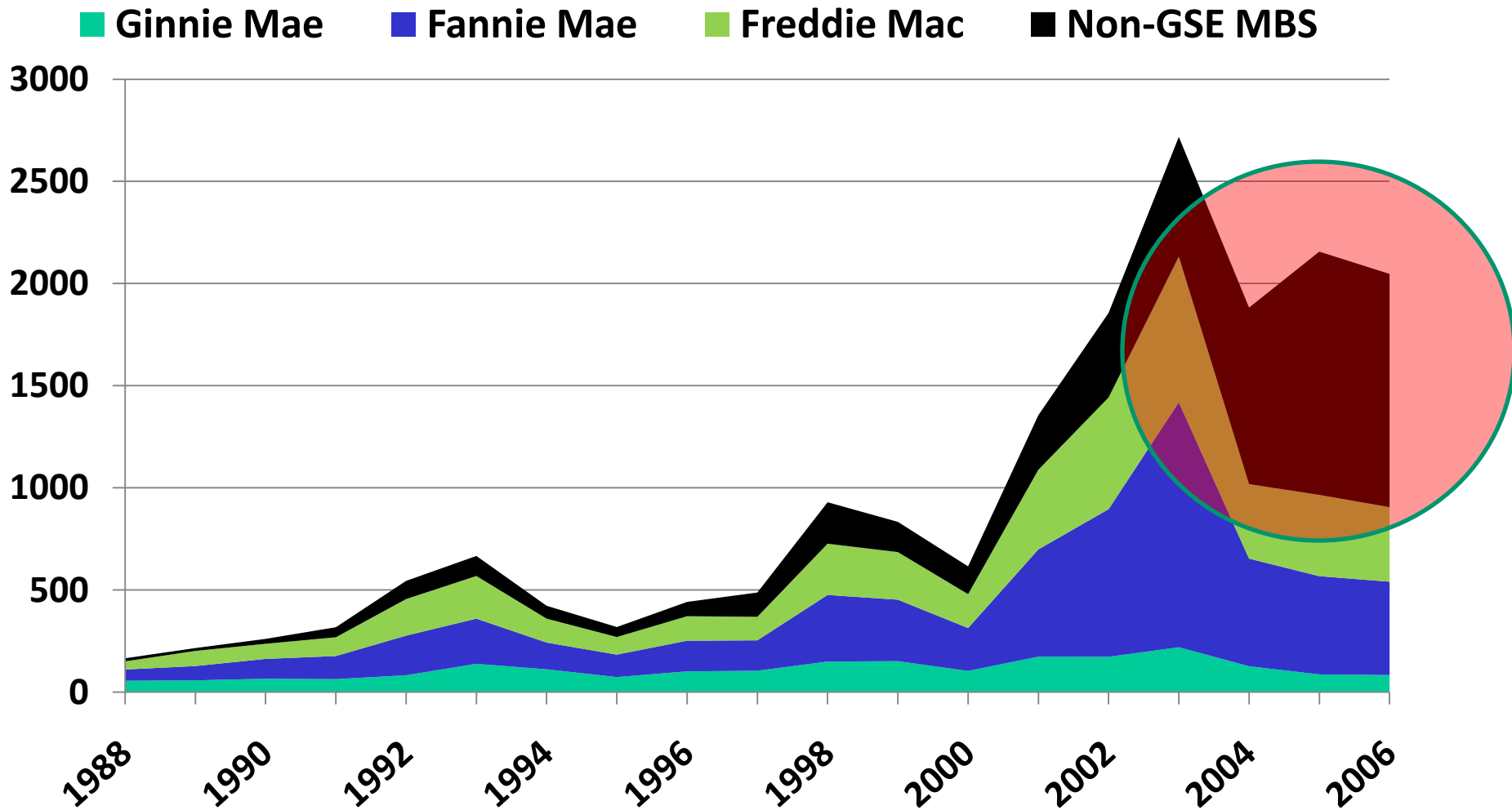


Median house price versus Median income



MBS Origination Shares, \$bil

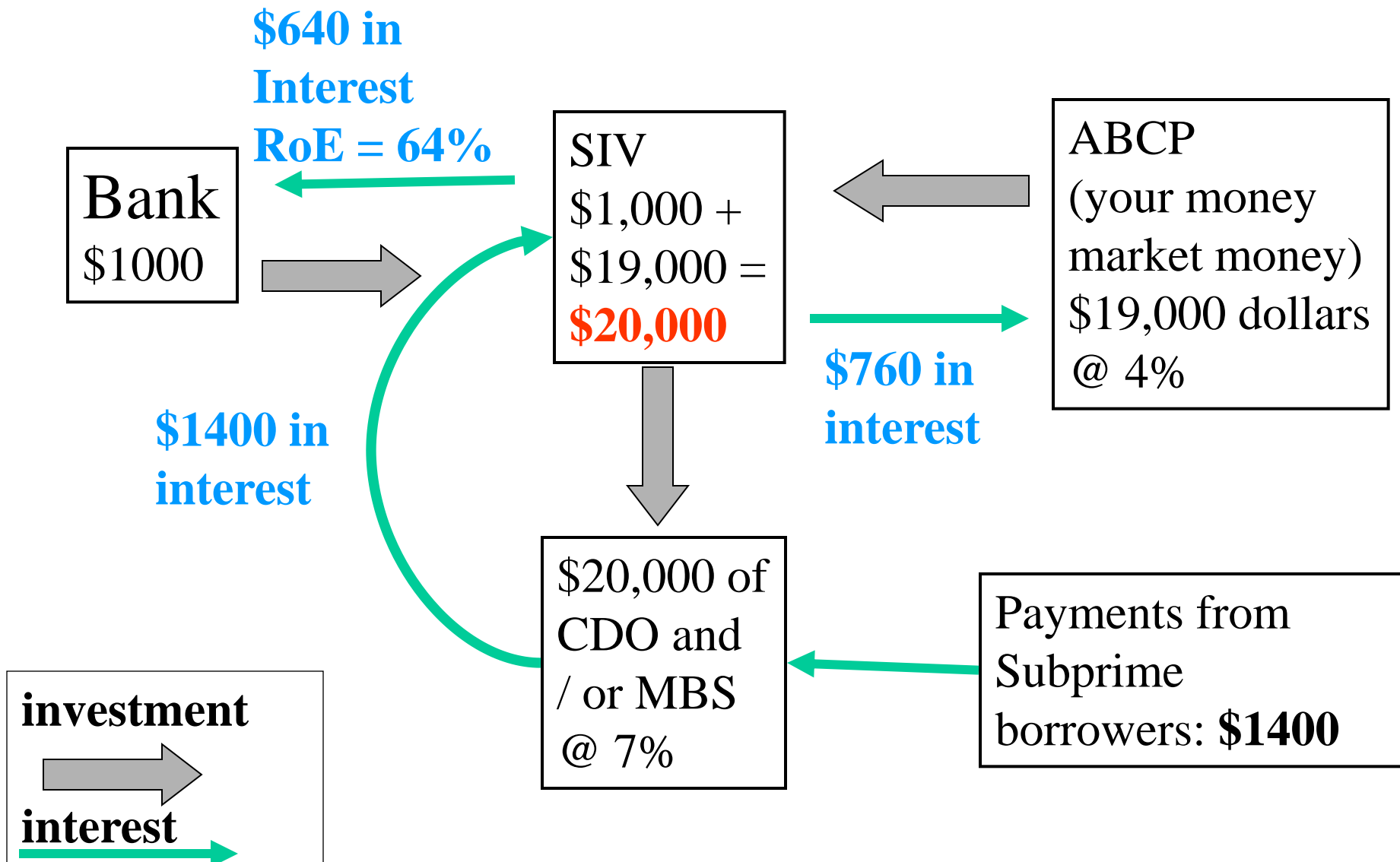
non-GSE MBS = subprime, Alt-A



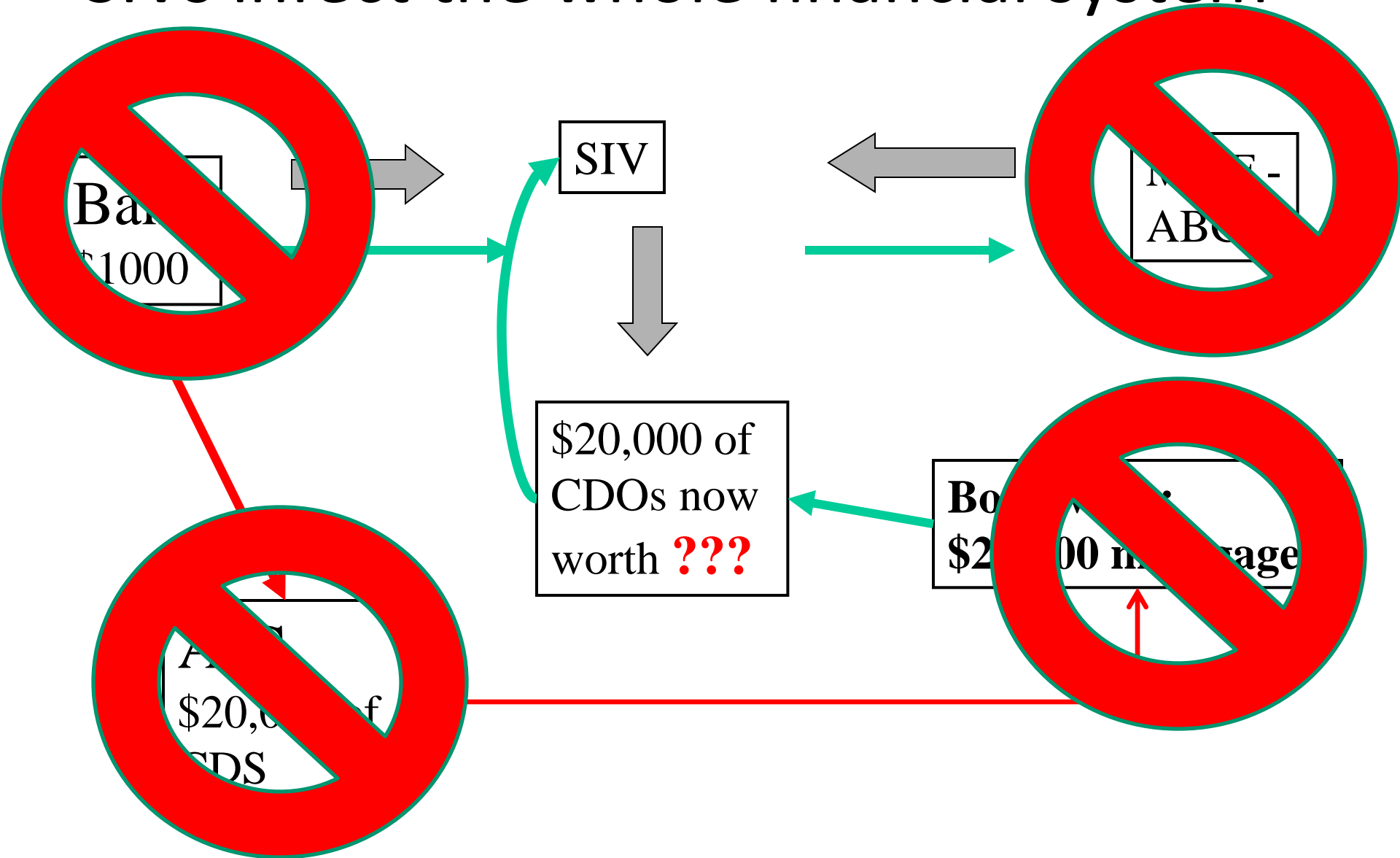
Recession was inevitable

- But not a financial collapse
- Why the catastrophe?
 1. CDOs put many banks (all types) at risk
 2. SIVs contaminated money market funds and thus the commercial funding system
 3. “naked” CDS bankrupted insurance companies => Investment Banks ↓↓

SIVs - money for nothing



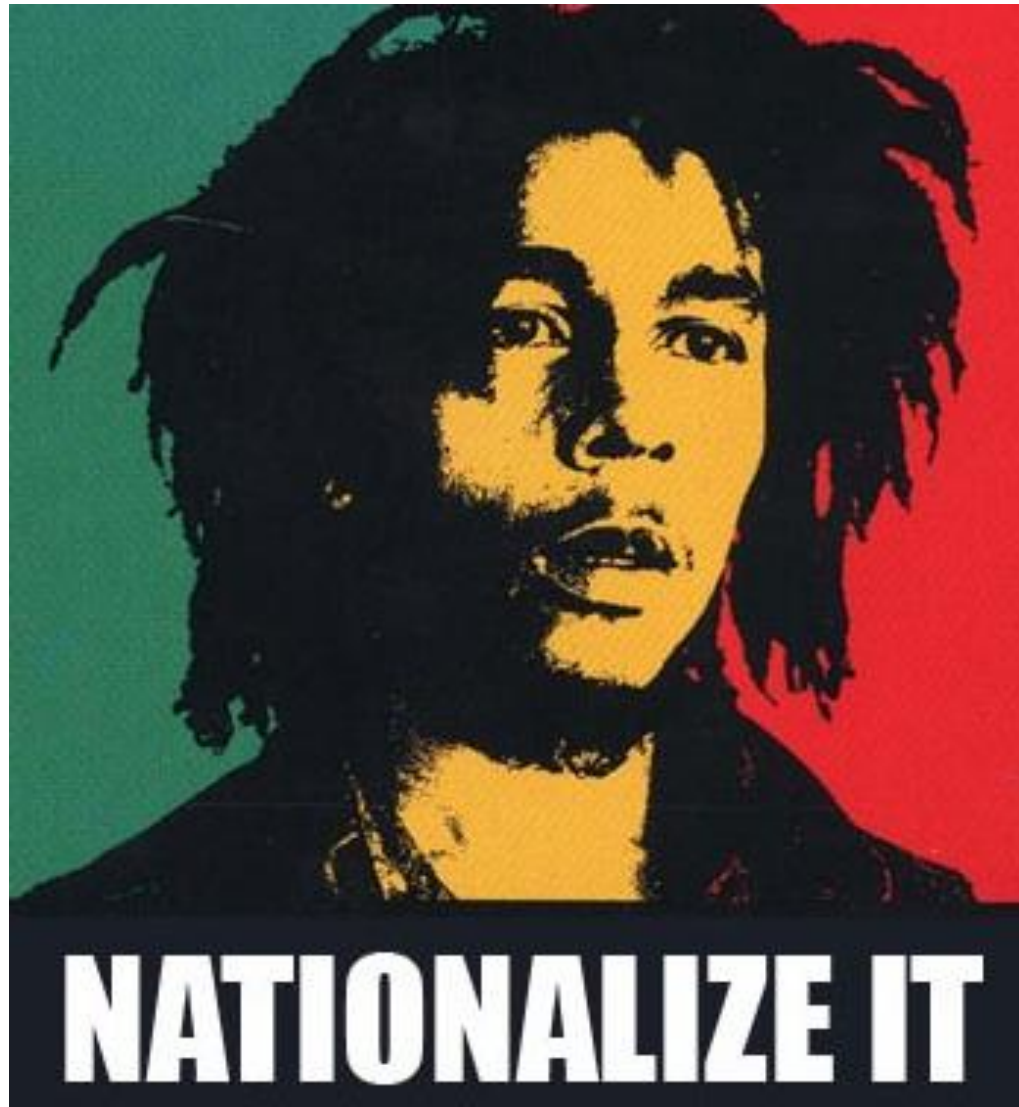
SIVs infect the whole financial system



Responses to the Crisis



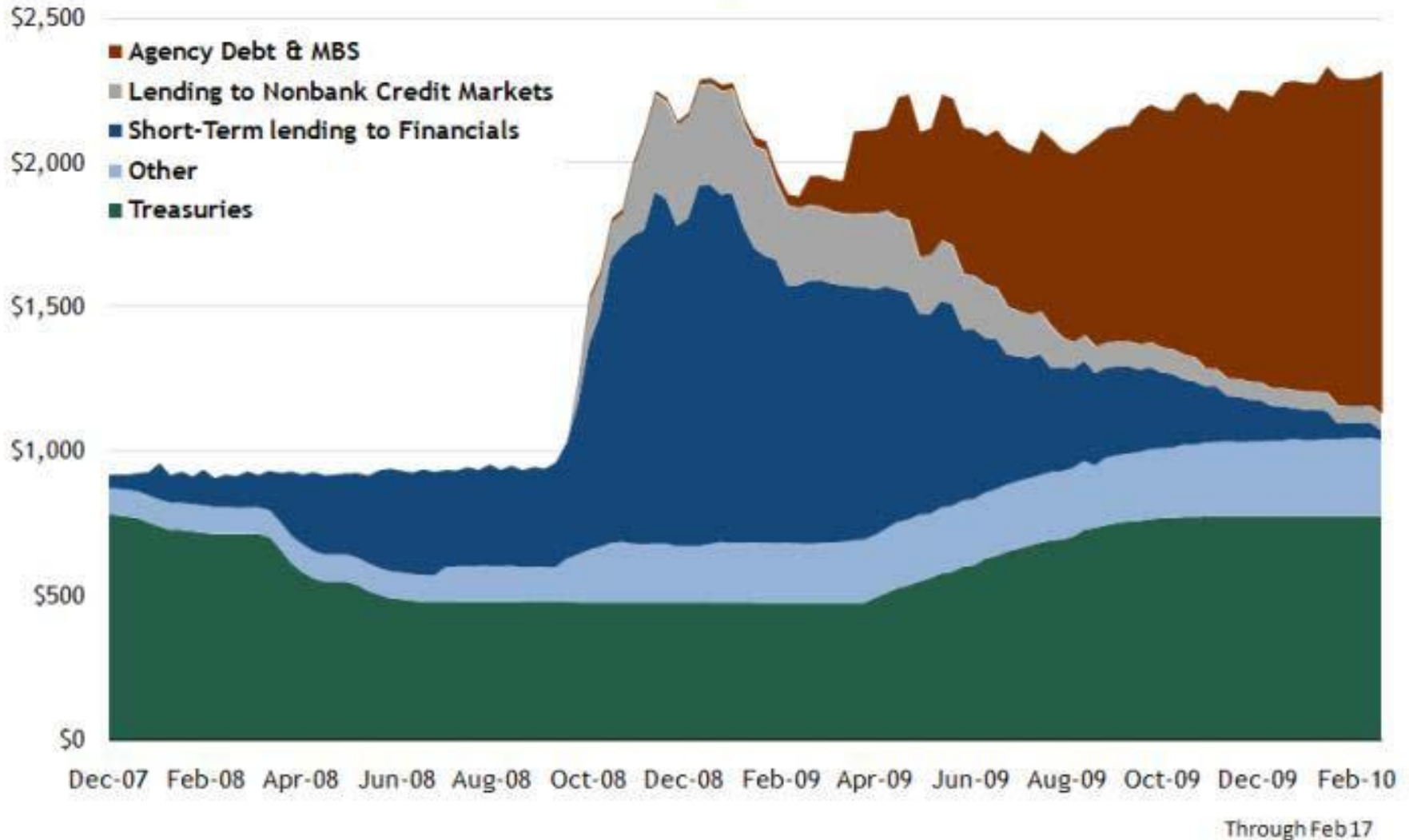
One policy solution... not taken



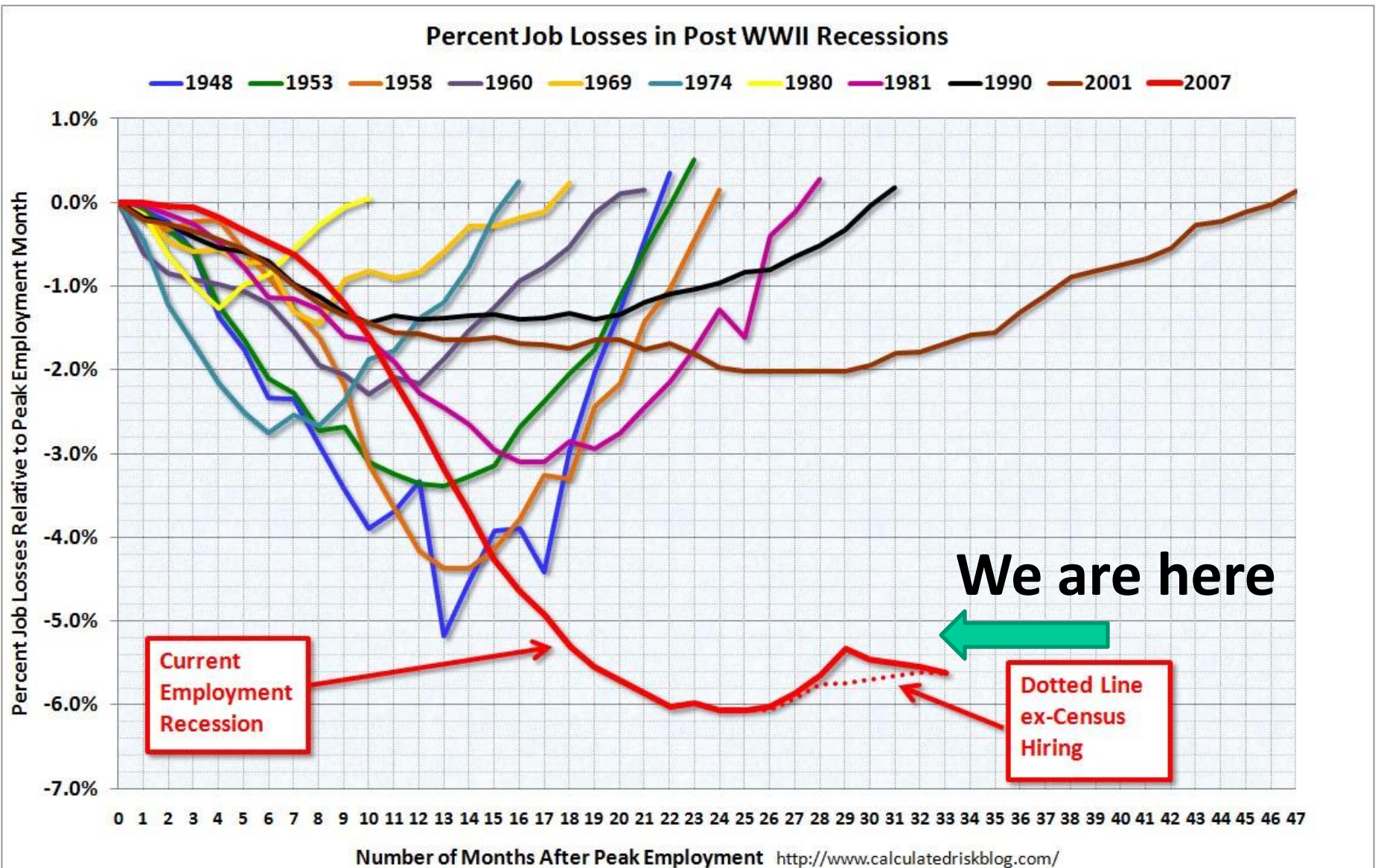
What the Fed did

Federal Reserve Assets (Uses of Funds)

\$ billions



% Job losses in post-1945 recessions



US trade deficit, 98-10



US and China

- US over-consumes (and borrows to consume)
- China over-produces (and invests too much)
- US\$ must fall versus Chinese RMB
- **But: China will not risk social disorder from unemployment; a stronger RMB means fewer exports**

US ... Veiled threats

“Global rebalancing is not progressing as well as needed to avoid threats to the global economic recovery. Our initial achievements are at risk of being undermined by the limited extent of progress toward more domestic demand-led growth in countries running external surpluses and by the extent of foreign-exchange intervention as countries with undervalued currencies lean against appreciation.”

Timothy Geithner, US Treasury Secretary
10/10/2010

...the Chinese line

“Do not work to pressurise us on the renminbi rate... Many of our exporting companies would have to close down, migrant workers would have to return to their villages. If China saw social and economic turbulence, then it would be a disaster for the world.”

Wen Jiabao, Prime Minister, China, 10/2010

Innocent (?) by-standers?

“We’re in the midst of an international currency war. This threatens us because it takes away our competitiveness.The advanced countries are seeking to devalue their currencies.”

“China pegged [its currency] to the dollar, it stayed in an advantageous situation.”

Guido Mantega, Brazil’s Finance Minister, 9/2010

Questions?



Predictions

