Anatomy of a Historic Economic Crisis

Weidenbaum Center Lecture Series
January – February, 2013
Part 2
Summary of Lecture #1

One picture is worth 50 minutes of lecture!!
Review of Lecture 1

- Basic perspective on the Great Recession
  - Historic in depth and persistence
  - Driven in large part by collapse of household demand (data)

- Change in direction of household debt relative to income (data)
Personal Outlays (Share of Disposable Income)

3-Month Moving Average
Cons. Boom Era
Personal Outlays (Share of Disposable Income)

3-Month Moving Average
Cons. Boom Era
Tonight’s Lecture

- Explore sources of financial instability
- What triggered the Great Recession
  - Difficulty of predicting the timing of turning points
- Now what? Challenges for the way forward
  - Where will demand come from without unsustainable household borrowing?
  - Role of inequality
- Set up policy discussion for February 27
Minsky and Financial Instability

WU Professor 1965–90

Impressive Company
Stability is Destabilizing

- General message: capitalism inherently unstable
  - Financial tranquility sows the seeds of its own destruction

- Why? Start with low debt, healthy balance sheets
  - Profit opportunities from more borrowing & lending

- Money is made; success encourages more aggressive/risky financial actions

- Financial fragility grows, system less stable
More aggressive finance generates profits
  ◦ Greater lending creates economic stimulus; faster growth; more cash flow to help validate debt
  ◦ Rising asset prices enhance collateral
  ◦ Expectations and confidence: “Success breeds a disregard of the possibility of failure”

Profit motive encourages system to extend lending even further, take greater risks
  ◦ Example: reduced down payment

Greed? Yes, but the engine of capitalism
Boykin Curry, managing director of Eagle Capital:

"For 20 years, the DNA of nearly every financial institution had morphed dangerously. Each time someone at the table pressed for more leverage and more risk, the next few years proved them 'right.' These people were emboldened, they were promoted and they gained control of ever more capital. Meanwhile, anyone in power who hesitated, who argued for caution, was proved 'wrong.' The cautious types were increasingly intimidated, passed over for promotion. They lost their hold on capital. This happened every day in almost every financial institution over and over, until we ended up with a very specific kind of person running things."

Quoted in Farid Sakaria column "There is a Silver Lining," Newsweek, October 12, 2008
Further Sources of Validation

- Falling interest rates
  - Legacy of “Great Inflation”
  - Fed policy to lower interest rates when economy sputters
  - Data: 30-year mortgage rate

- Rising home prices
  - Data: Case–Shiller Index

- “Perfect storm”
U.S. Nominal Mortgage Interest Rates

30-Year Fixed Mortgage Rate


30-Year Fixed Mortgage Rate
Case–Shiller Home Price Index (through 2006)
Rising Financial Fragility -- Households

- Household financial structure becomes more precarious; sowing the seeds of failure
  - Debt to income
  - Quality of mortgages; terms of lending

- How can someone with a $30,000 annual income afford a $300,000 house?
  - Low, “teaser” interest rates
  - Expectation that rising home value will support future cash-out refinancing
Rising Financial Fragility -- Lenders

- Complexity of financial arrangements
- Securitization; multiple layers
  - Concern that originator has “no skin in the game”
  - Not so simple; someone has to buy the paper
  - But complexity obscured information
- Credit default swaps
  - Insurance without reserves; false sense of security
  - Buying insurance on someone else’s assets
“Consumer Age” Source of Growth

- Cynamon and Fazzari (2008, 2012, chapter 6)
- Demand stimulus from household borrowing
  - Helps to create “Great Moderation”
  - Sense of “new economy” with faster, more stable growth provides more validation
- Minsky: “fundamental direction of instability is upward.”
  - Validation and Fragility
  - Occurs endogenously; inherent to “money-manager” capitalism
Was It Rational? Was it Stupid?

- Alan Blinder “First Financial Commandment”
  - Always remember that people forget (link to Minsky)
  - “When good times roll, expect them to roll indefinitely.” (NYT, January 19, 2013)
  - And households, and banks, ...

- Micro perspective vs. systemic uncertainty
  - What to do in uncertain world? Rely on convention
  - Old data to assess fundamentally new structure

- Housing, not tech stocks/oil patch/farm land ...
  - Some see just isolated lessons
  - Minsky’s genius to see family resemblance
  - Timing almost impossible to predict; hard to establish credibility
The “Minsky Moment”

- Financial fragility hits breaking point; boom turns to crash

- Why?
  - Inflation fear leads to rising interest rates (data)
  - Interrupts re-financing cycle
  - “Plan B:” sell the house you can no longer afford
  - Asset prices stretch credibility
  - End of home price boom (data)

- Stress test metaphor
Case-Shiller Home Price Index

- 34%
What Comes Next?

- Conventional wisdom: slow improvement; no significant structural change
  - Recovery should “gain traction”
  - Slow dampening of expectations

- But no serious spending growth without “repair” of household balance sheets
  - Minsky cycle prediction: financial shake out cleanses financial excess
  - Ultimately restarts upward instability
  - How long?

- End of “Consumer Age”
Arithmetic of Demand

- SF perspective: demand not automatic
- The components
  - Consumption (71.2%)
  - Residential Construction (2.6%)
  - Business Investment (10.4%)
  - Government Spending
    - Federal (7.6%)
    - State & Local (11.7%)
  - Net Exports (−3.5%)
- What fills the gap? Do we need to re-energize consumer spending?
Data

Paradox: Rising inequality should create “demand drag”
- Pretty good demand growth in Consumer Age
- Why? Falling saving rate; rising demand rate (data)

“Rich” recycle income to demand by lending to middle class
Income Share of U.S. Top 5% (Pre-Tax)

Excluding Capital Gains
Disaggregated Demand Rates

Higher household debt in bottom 95% (data)

More nuanced perspective: unsustainable spending and borrowing for group getting lower share of income
  ◦ Unsustainable spending about 8% of GDP by 2006

Postponed demand drag from inequality

Minsky’s “cleansing” may not fix this problem
Unsustainable Trends

Debt to Income Ratio - Survey of Consumer Finance

- 5th to 20th Percentile
- 20th to 95th Percentile
- 95th Percentile and Above
What Can Be Done?

- Partial explanation for current stagnation:
  - Lost about 0.5% of demand growth
  - No obvious replacement
  - A structural problem => just waiting not enough

- Monetary and fiscal policy
- Institutional reform