

Brookings Panel on Economic Activity

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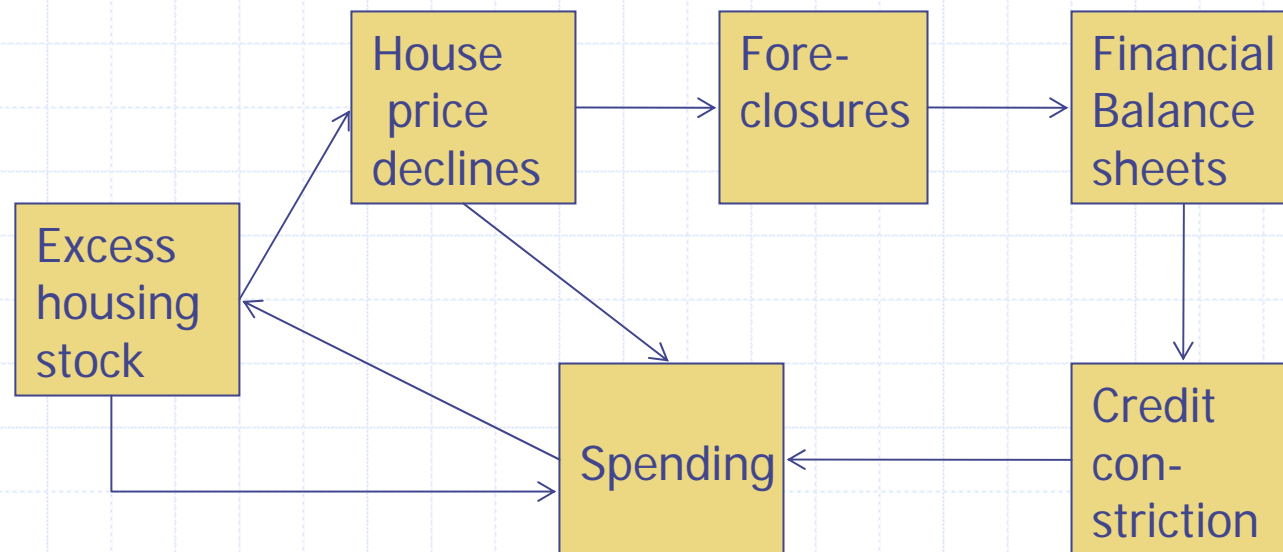
Resident Scholar

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◆ *September 11, 2008*

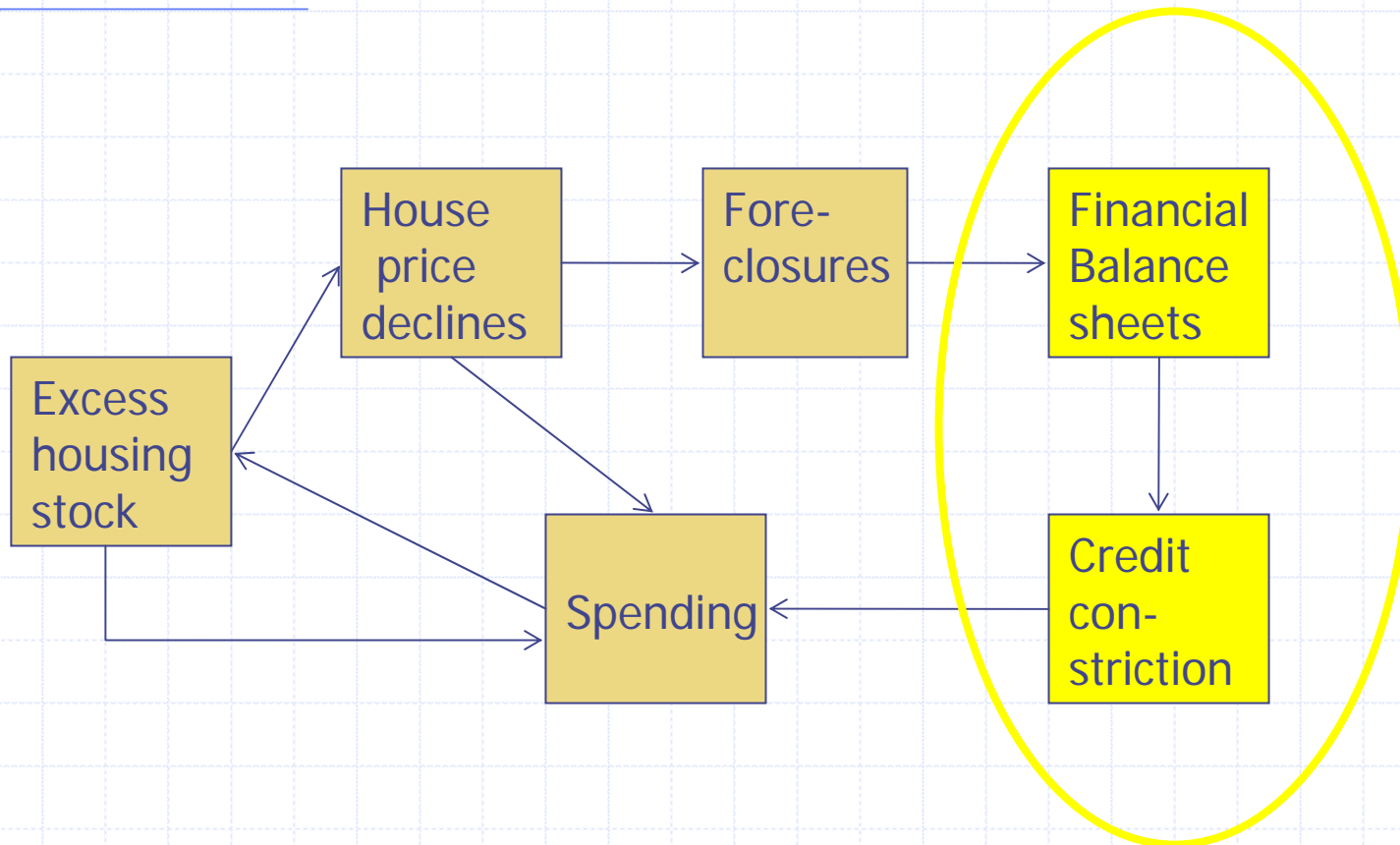
- ◆ Identify the commonality in the three papers in this session
- ◆ Argue that there is an omission in
 - The three papers and
 - The understanding of policy makers judging from their actions
- ◆ Offer specific comments on the three papers

Over the past year, the chief impediment to spending and the major concern to policy makers has been that an adverse dynamic takes hold

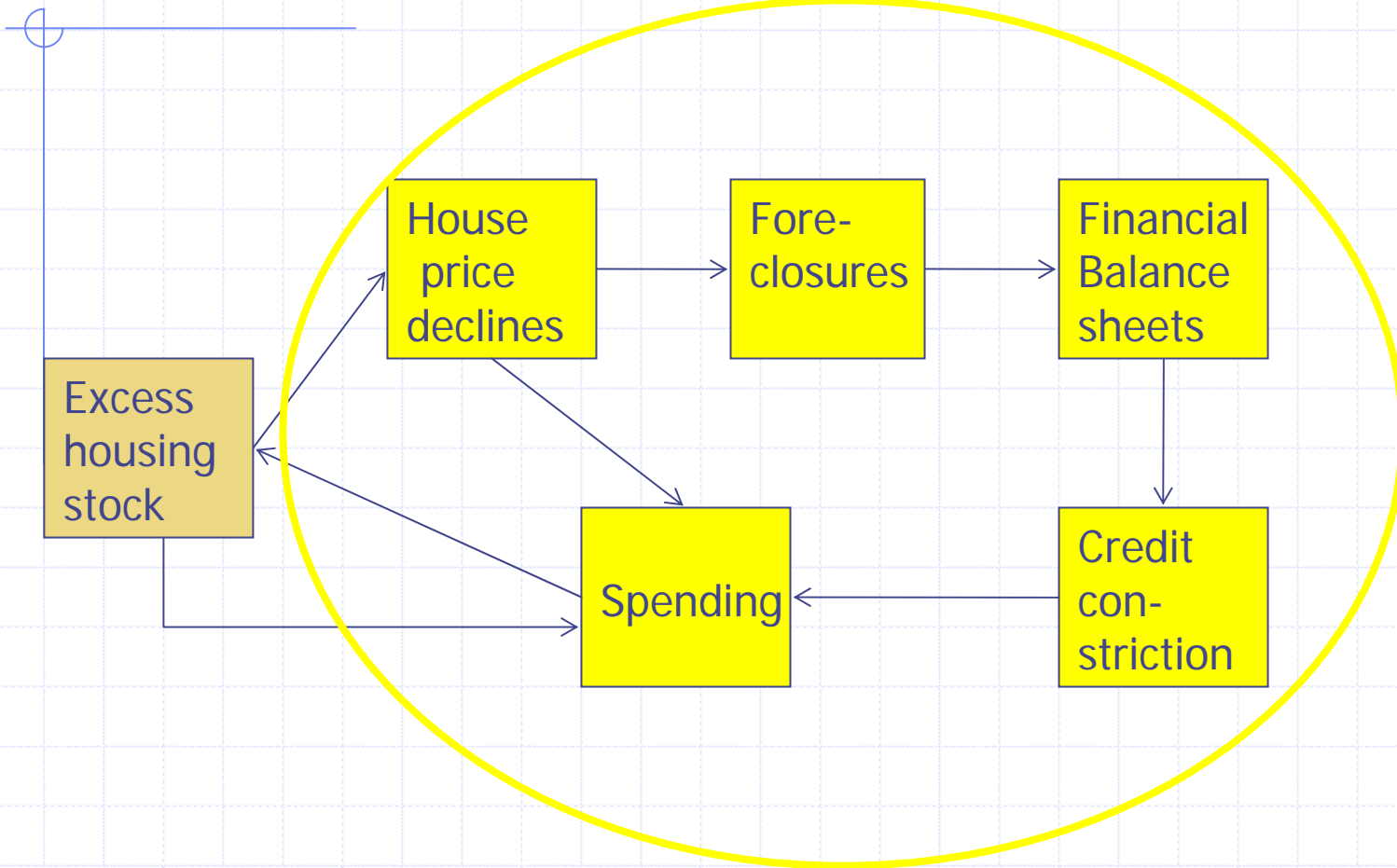


The three papers in this session deal with aspects of this dynamic mechanism

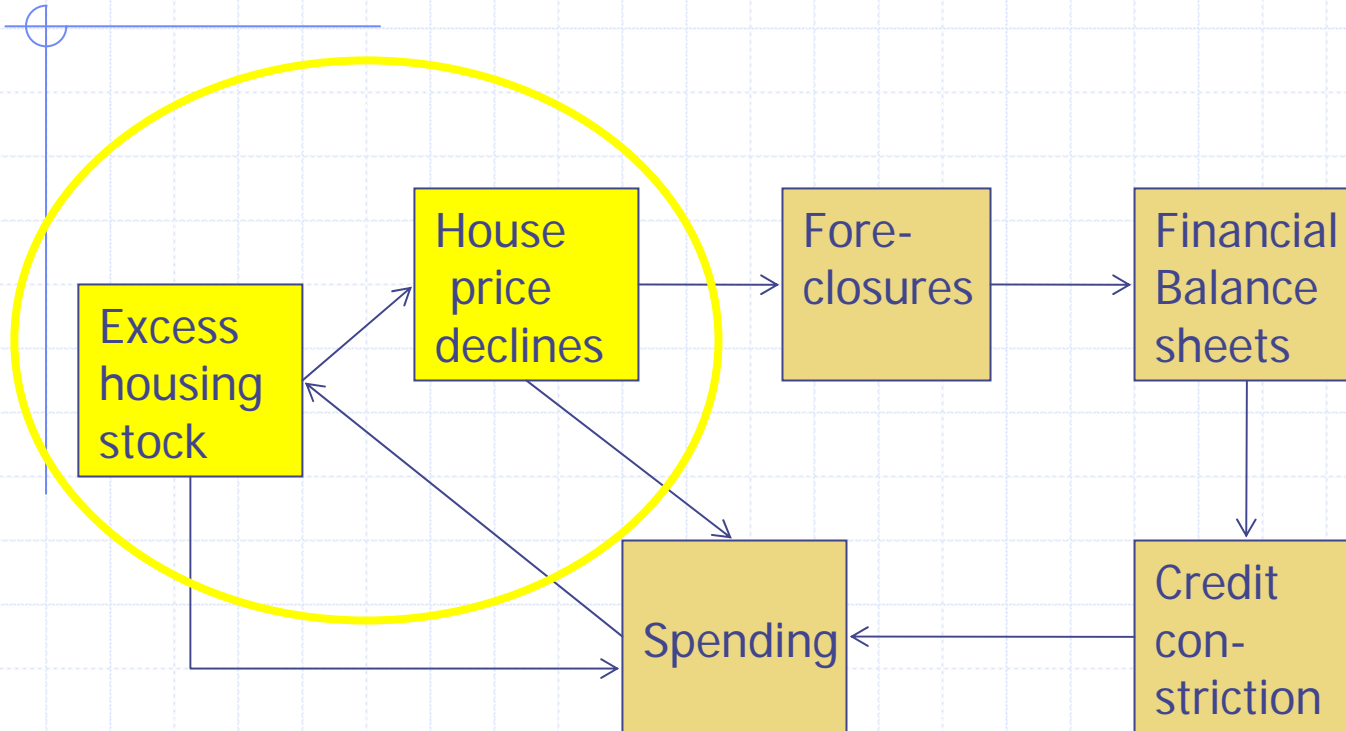
Morris and Shin, "Financial Regulation in a System Context"



Hatzius, "Beyond Leveraged Losses: The Balance Sheet Effects of the Home Price Downturn"



Case, "The Central Role of House Prices in the Financial Crisis: How will the Market Clear?"



The essential problem is that these papers and policy making have treated the map of the economics of house price adjustment

◆ as conceptually identical to this map >

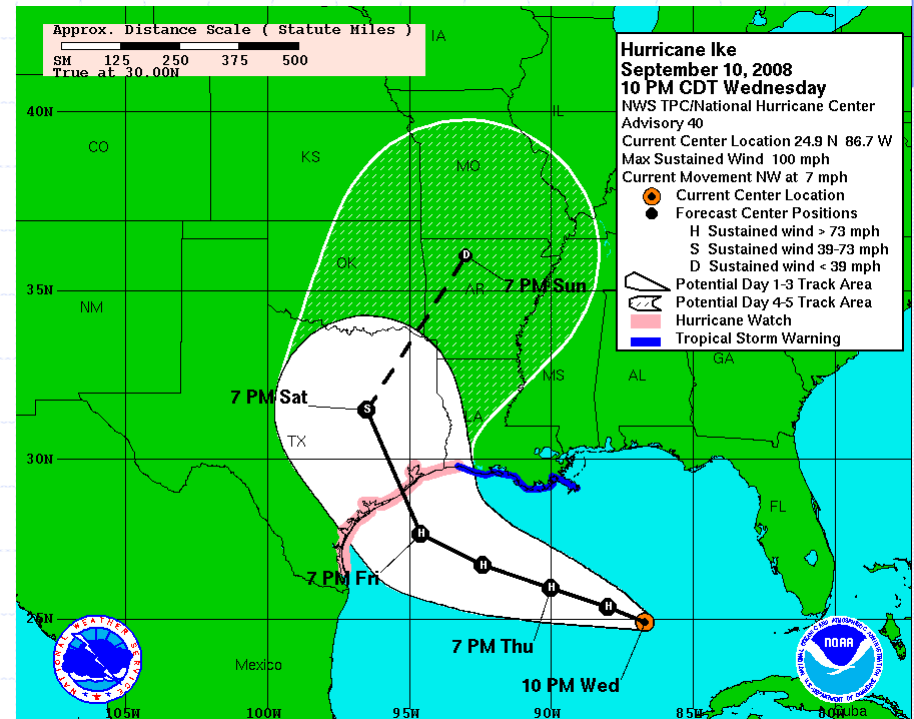
- As a force of nature imposed on the market with a path invariant to policy

◆ Words reveal this attitude:

- “the perfect storm”
- “the hundred year’s flood”

◆ When policy is discussed (M&S),

- It is in structural, or long-run, terms



This neglects that policy may have shaped the contours of this crisis . . .

◆ Market activity and asset pricing

- Have important expectational components
- Involve issues related to the coordination of beliefs
- May tend to multiple equilibriums

◆ Policy interventions by the Federal Reserve and the Treasury,

- while being ambiguous as to the scale and scope of the protection offered,

◆ created incentives

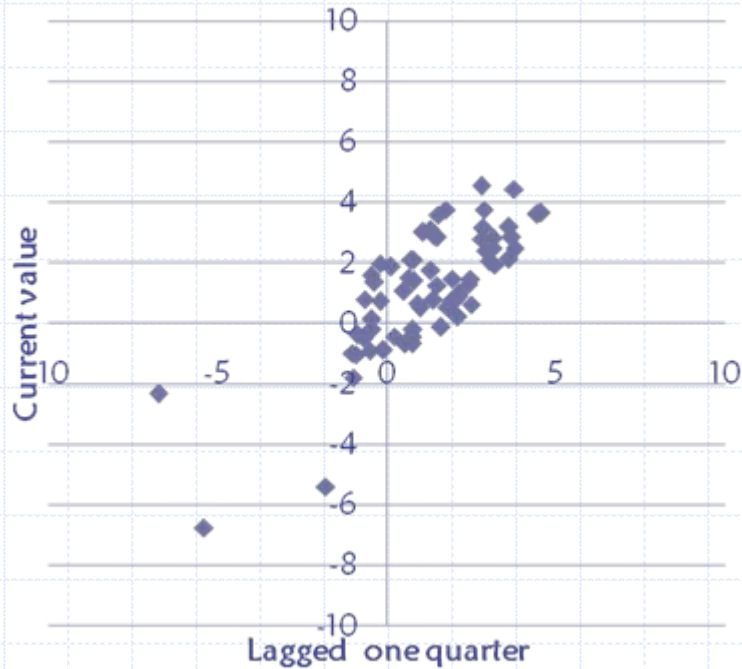
- For firms with capital deficiencies to postpone adjustment
- For creditors and short sellers to test the limits of intervention

What is the initiating economic loss?

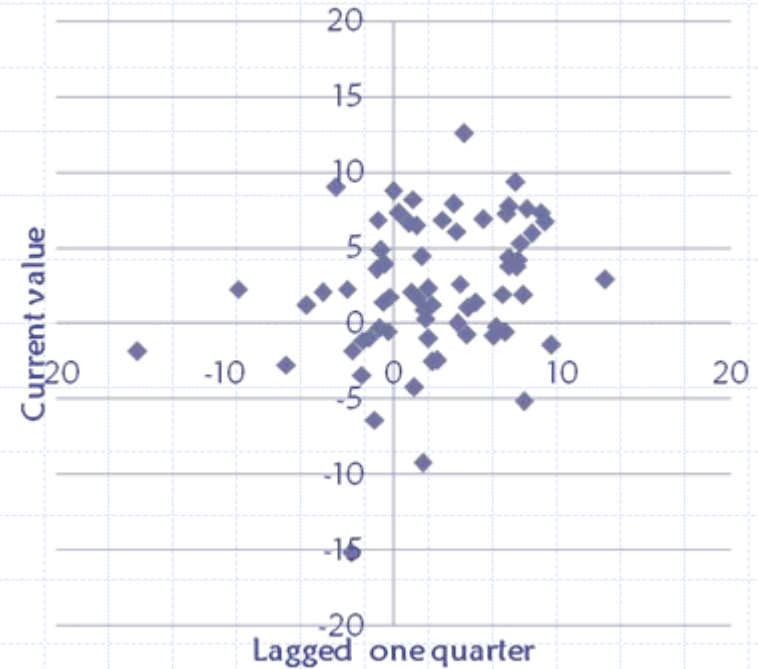
Case: The central role of house prices

House prices do not behave like other asset prices

Growth in Case-Shiller home prices



Growth in S&P 500



Mechanisms producing this stickiness include

- ◆ Owners have discretion as to whether to put the house on the market
- ◆ As sellers, they have discretion on
 - Listed prices
 - Search intensities
 - Time on the market
 - Inclusion of amenities
- ◆ As buyers, they have discretion on
 - Search intensities
 - Time in the market

These are mechanisms that make prices inertial, not the underlying reasons for the inertia. Two sets of insights from the macro literature may help in understanding

◆ Prices can be inertial because of:

- Staggered contracting
- Menu costs
- Sticky information

◆ Dynamics can be thought of as:

- A sharp and marked decline in the shadow price of housing
- Transactions prices slowly catch up

◆ Question: Which behaviors depend on the shadow price and which depend on transactions prices?

What are the broader economic consequences of a decline in house prices?

Hatzius: Beyond Leveraged Losses

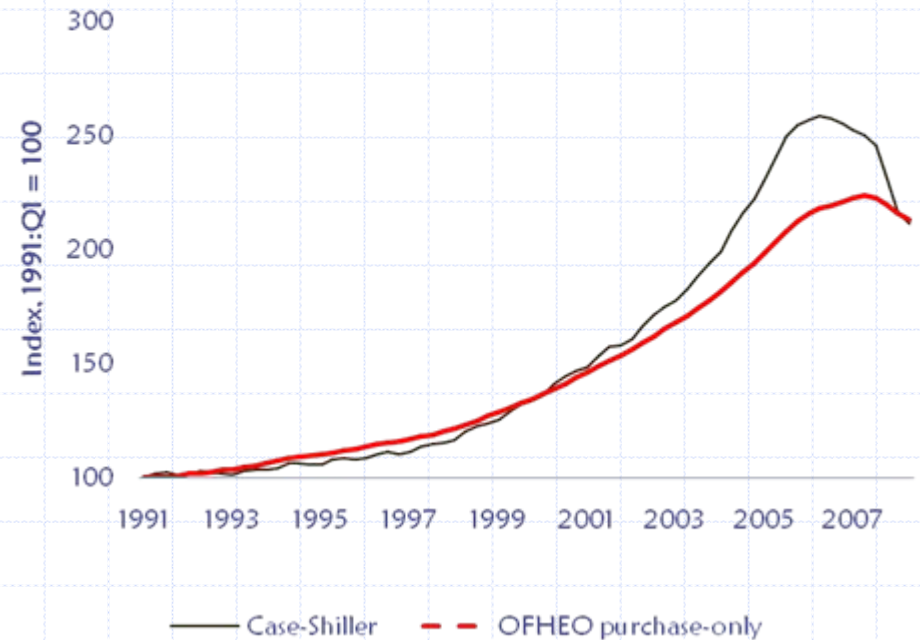
The Hatzius paper

- ◆ Is a careful disaggregated approach articulating the channels of influence
 - Takes advantage of regional variation in home prices for which there is some precedent for declines
 - Acknowledges, but does not always address, econometric complications due to data limitations
- ◆ Three main points
 - From small to large

1. In the disaggregated description of the channels of effects of house price changes, Hatzius

- ◆ Uses auxiliary regressions to explain OFHEO state indexes with the national Case-Shiller index
- ◆ At the national level, though, the two series begin and end at the same point 27 years apart

U.S. home prices



The change-on-change regression

Regression of the quarterly growth in the national OFHEO repeat-purchase index

1991:Q2 to 2008:Q2

Constant	0.63
	<i>0.07</i>
Growth in Case-Shiller Index	0.36
	<i>0.03</i>
Lagged ratio of price indexes	-0.06
	<i>0.02</i>
² R	0.74

Standard errors are in italics.

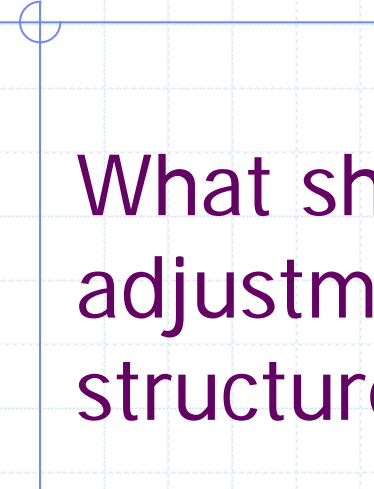
- ❖ Cannot explain the convergence of the two series
- ❖ An error-correction mechanism does explain the two national series
 - Which has consequences for long-run scenarios

2. As to the effects of debt on activity

- ◆ There is a significant doctrinal history about this predictive relationship
 - Part of the BPEA over the past three decades
 - One reason the Federal Reserve had a debt aggregate for so long
 - That literature discussed many aspects of the technical difficulties in estimation

3. The paper calls attention to the critical role of the government sponsored enterprises

- ◆ If Fannie and Freddie are required to shrink their balance sheet along with everyone else,
 - Macroeconomic loss is considerably larger
- ◆ Therein is the Treasury's uncomfortable choice
 - Is the intervention
 - ◆ About bolstering the credit worthiness of two firms or
 - ◆ About offsetting some of the unusual restraint in the mortgage market?
 - Seen in the difference between the discussion of legislation in July and in the actions last weekend
 - ◆ Having got into the macro-stabilizing game, the Treasury is accepting significant new responsibilities



What shapes the balance sheet adjustment and how should policy be structured?

Morris and Shin: Financial Regulation in a System Context

Building on their earlier work, the M&S paper addresses the underlying behaviors driving balance sheet adjustment

- ◆ Examines the issues in terms of first principles
- ◆ Essentially suggests viewing the map of economic adjustment from a different perspective
 - In terms of the systemic consequences of market activity
 - Important in terms of understanding the aggregate consequences of individual behavior
- ◆ Personally reluctant to adopt fully a perspective that maps systemic concerns into a separate analytic framework
 - Might be distancing from understanding the underlying behaviors leading to market failure
 - ◆ The discussion of Pigovian taxes at the end is more accessible
 - Invites bureaucratic capture of “systemic risk management”
 - ◆ BIS, CGFS, FSF, IMFC, G7, G20, G30, BCBS, and WWF

Examples that everything old is new again

◆ *Proposition 1: Actions that enhance the soundness of an individual institution undermines the stability of the system as a whole (p. 6)*

- Fallacy of composition
- “Paradox of deleveraging” (McCulley)

Proposition 3: There is a distinction between risky assets and systemically important assets (p. 11)

- ◆ An asset serves multiple roles and can have different prices
 - Treasury securities can be held outright or used as collateral (Duffie)

- ◆ An asset price may embed a loading on the risk of an infrequent liquidity crisis
 - LTCM sold insurance on tail risk through RPs, equity volatility, and relative spread arbitrage (Cochrane)
 - What is it about expectations, utility, and coordination?

Where Bear Stearns went wrong: The problem was on the liabilities side of the balance sheet (p. 3)

- ◆ In the literature on auctions and debt management, a concentration of short-term liabilities is referred to “Italian Risk”
 - Not politically incorrect, in that it was Alesina and Tabellini who named it

Main message from my reading of the three papers

- ◆ Clear reviews of the channels of influence of house price declines
- ◆ But markets with an important role for expectations can produce
 - Herding
 - Self-fulfilling prophecies
 - Multiple equilibriums
- ◆ In that environment, policy matters for more than shaping long-run incentives
 - The world in part is of our making

