


Five questions relevant to where we go from here

Vincent Reinhart
The American Enterprise Institute

October 9, 2009

No way out?



- 
- ◆ Why are U.S. households so undiversified?
 - ◆ How should we manage a crisis?
 - ◆ How should we deal with troubled financial institutions?
 - ◆ What has been the role of the international sector?
 - ◆ How should the Federal Reserve respond to asset prices?

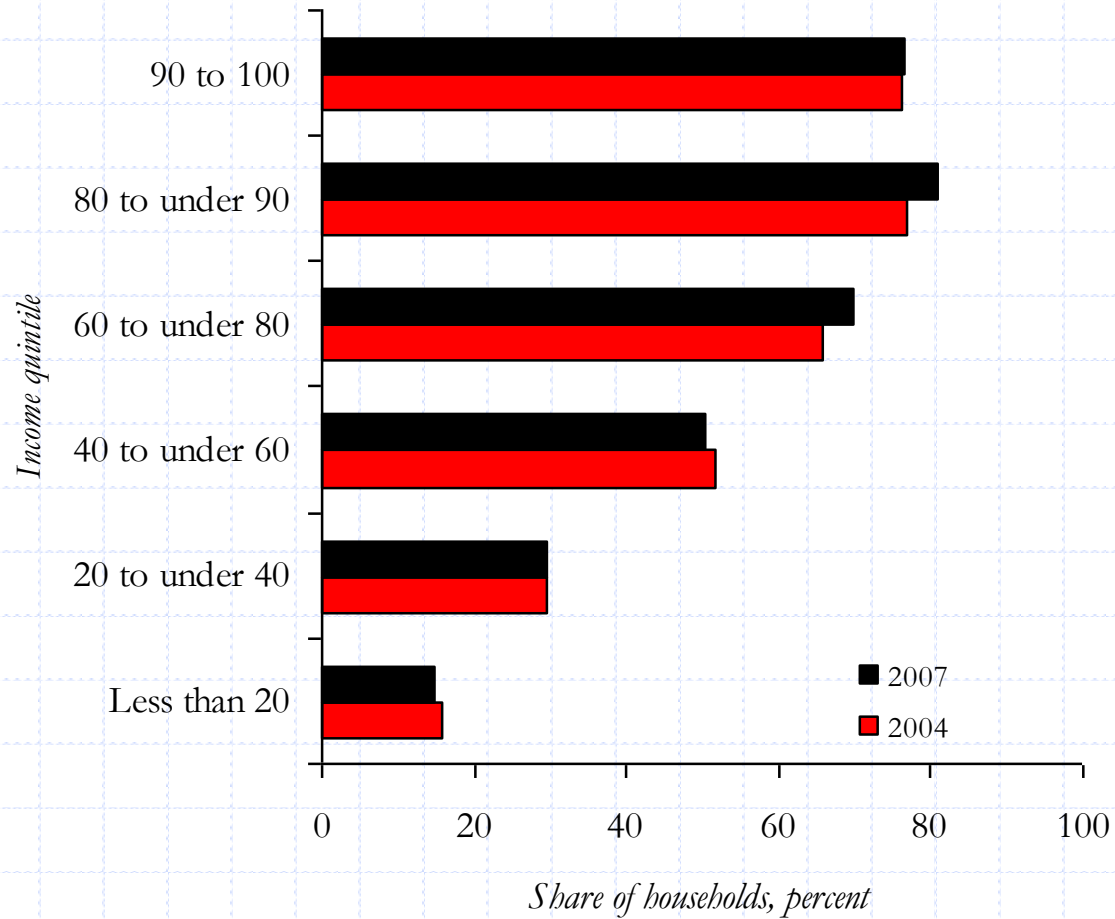


1. Why are U.S. households so undiversified?

The U.S. government provides considerable encouragement to home ownership.

- ◆ Tax deductibility of mortgage interest payments
- ◆ The housing related government sponsored enterprises (GSEs) created a market for mortgage securitization and hold large volumes of whole loans and securities.
- ◆ The Federal Reserve grants the GSEs direct access to the payment system and facilitates the clearing and settling of their securities.
- ◆ Regulatory guidance encourages housing activity, especially in underserved areas.
 - This encouragement was formalized in the Community Reinvestment Act, reporting requirements in the Home Mortgage Disclosure Act, and affordable housing guidelines for the GSEs.

Debt secured by primary residence



Family holdings of financial assets in 2007

percent

<i>Across percentile of income</i>	<i>Share of families holding asset</i>		<i>Memo: House values as a share of all assets</i>
	<i>Direct stock</i>	<i>Primary residence</i>	
Less than 20 percent	5.5	41.4	47.1
20 to under 40 percent	7.8	55.2	51.8
40 to under 60 percent	14	69.3	48.4
60 to under 80 percent	23.2	83.9	45.3
80 to under 90 percent	30.5	92.6	44.5
90 to 100 percent	47.5	94.3	19.8

Source: Federal Reserve, *Survey of Consumer Finances*

The housing bubble, the financial crisis, and the policy response

◆ Have been shaped by the facts that

- The government encourages levered bets on housing
- Avenues for wealth creation are limited for lower income households
- Households are under-diversified, with much of their wealth in homes

◆ This focus on housing

- Created retail encouragement to the housing bubble
- Erected a political barrier protecting the institutions facilitating the bubble
- Raised the importance of protecting those same institutions when in distress



2. How should we manage a crisis?

Four rules of bailouts

Rule 1: Don't do them

- ◆ The possibility of government intervention has consequences for the private sector, the government, and the political process
- ◆ The private sector
 - Lessens pressure on management to raise capital and address balance sheet problems
 - Lessens counterparty discipline
- ◆ The government
 - Opens agencies to political pressure
 - Confuses the public about policy intent
 - Eliminates forever the possibility of serving as an “honest broker”
- ◆ The political process
 - Tilts the political playing field toward intervention generally
 - Legitimizes increased supervision and regulation of a wide portion of financial activity

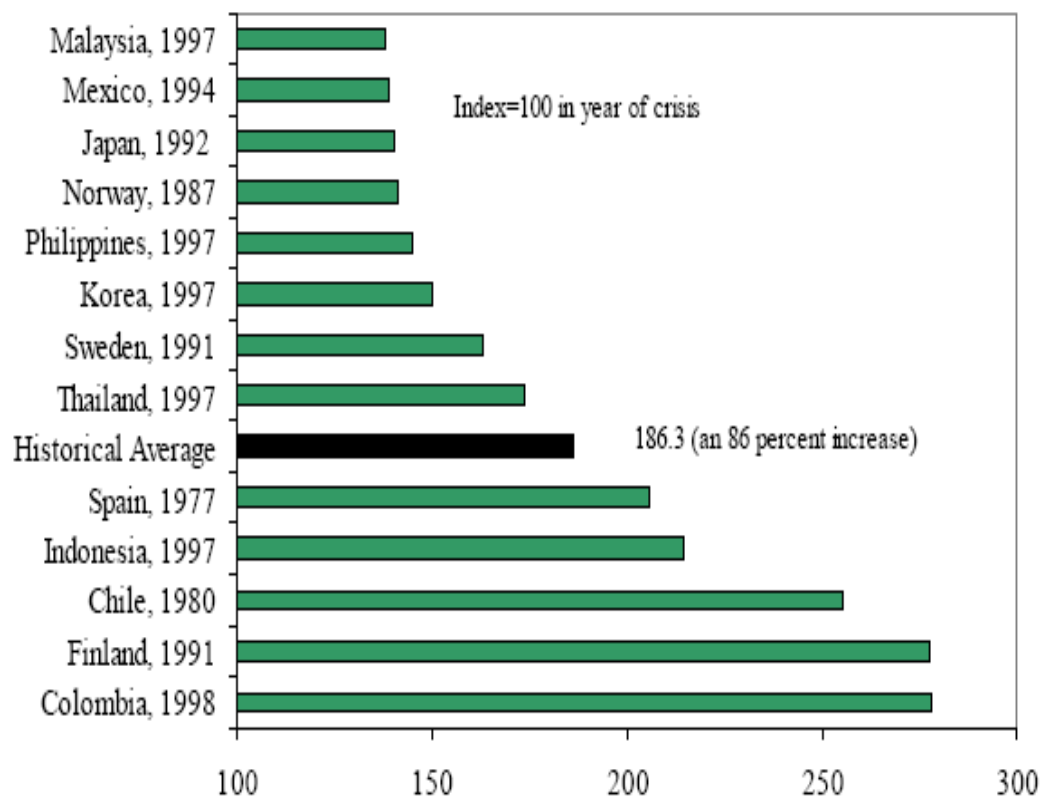
Rule 2: If you break rule one, be consistent

- ◆ Policy interventions by the Federal Reserve and the Treasury in 2008
 - were ambiguous as to the scale and scope of the protection offered
- ◆ This created incentives for creditors and short sellers to test the limits of intervention
 - So, the fear of debt contagion led policymakers to act in ways that encouraged speculative attacks

Rule 3: If you break rule two, be prepared to spend a lot

- The possibility of intervention leads investors to delay capital investments
- Given a capital hole,
 - If the private sector does not fill it,
 - The government will have to

Public debt three years after a crisis



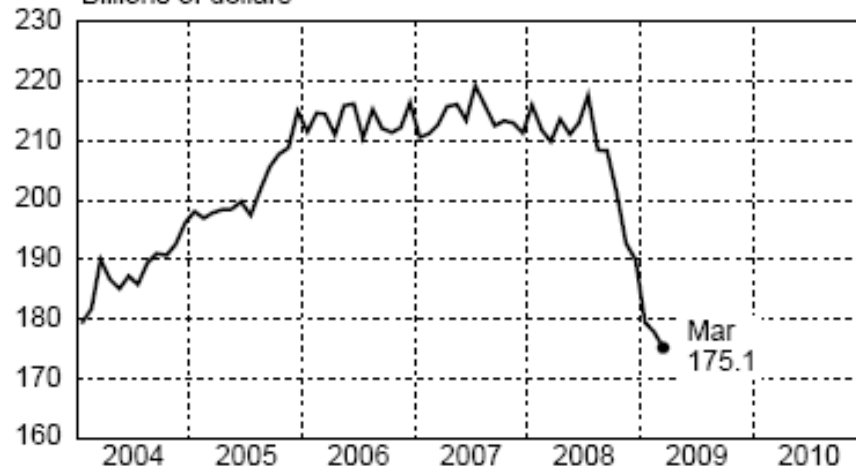
Rule 4: Whatever you do, don't add to uncertainty and worsen confidence

- ◆ Statements in the Fall (TARP/AIG) and the Spring (stimulus/market repair)
 - Added to uncertainty
 - Damaged confidence
- ◆ This is a problem inherent in the brinksmanship of bail-outs
 - Political salesmanship does not always align with economic stewardship

Institute for Supply Management (Manuf)
PMI Composite Index



Durable Goods
Billions of dollars



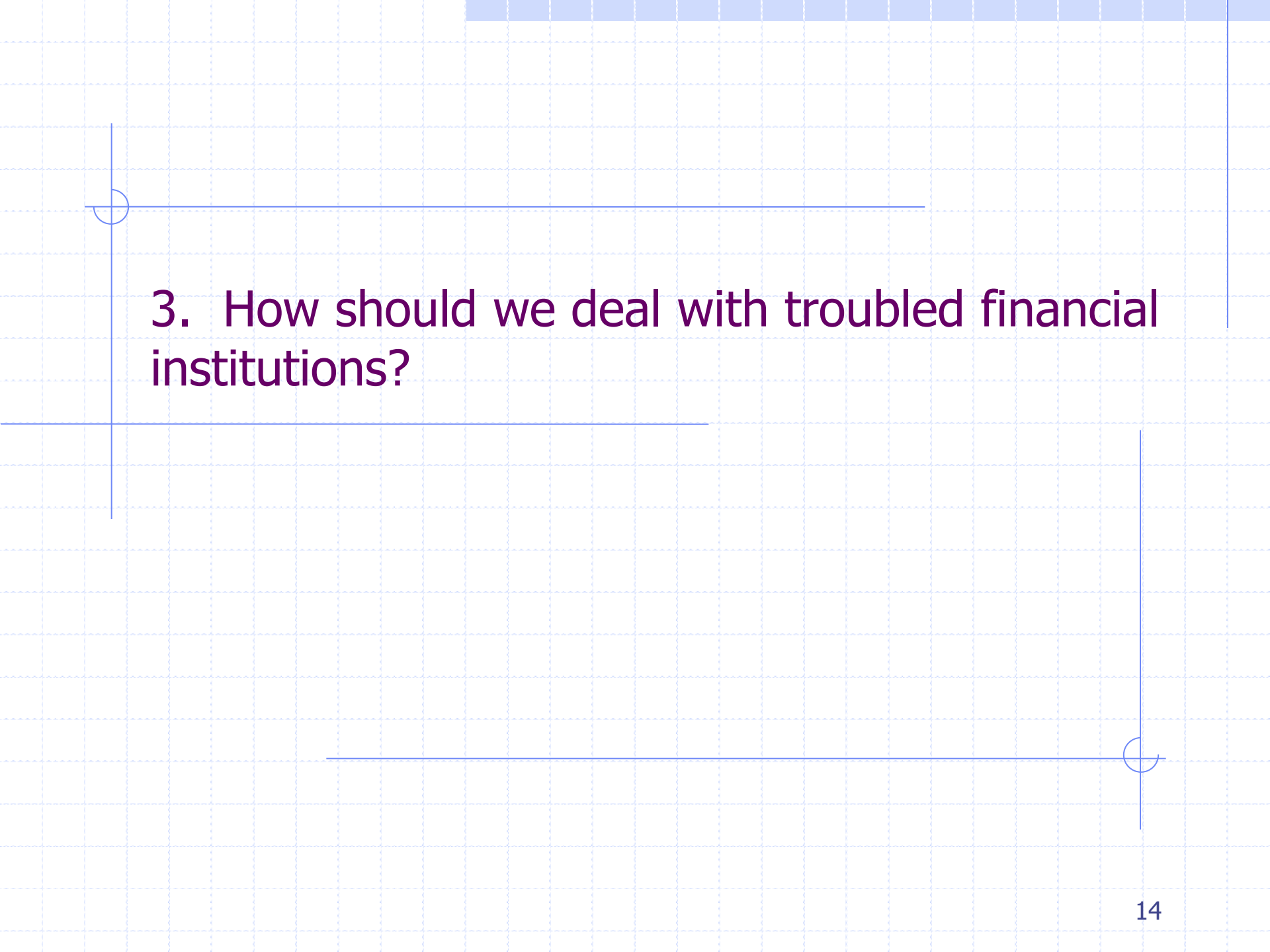
As a consequence of missteps in management of the crisis

◆ Policy makers amplified the shock

- They were not victims of a “perfect storm” or a “hundred-years flood”
- They were the Army Corps of Financial Engineers making decisions on dikes and levees upstream that had consequences downstream

◆ The government

- Has a considerable ownership stake in financial organizations
- Has widened the perimeter of its safety net



3. How should we deal with troubled financial institutions?

There are three core issues in dealing with troubled financial institutions.

◆ *When to recognize loss*

- in the value of legacy assets sufficiently to reflect the bursting of the bubble?

◆ *Who assumes loss*

- to fill holes on financial balance sheets associated with the recognition of loss?

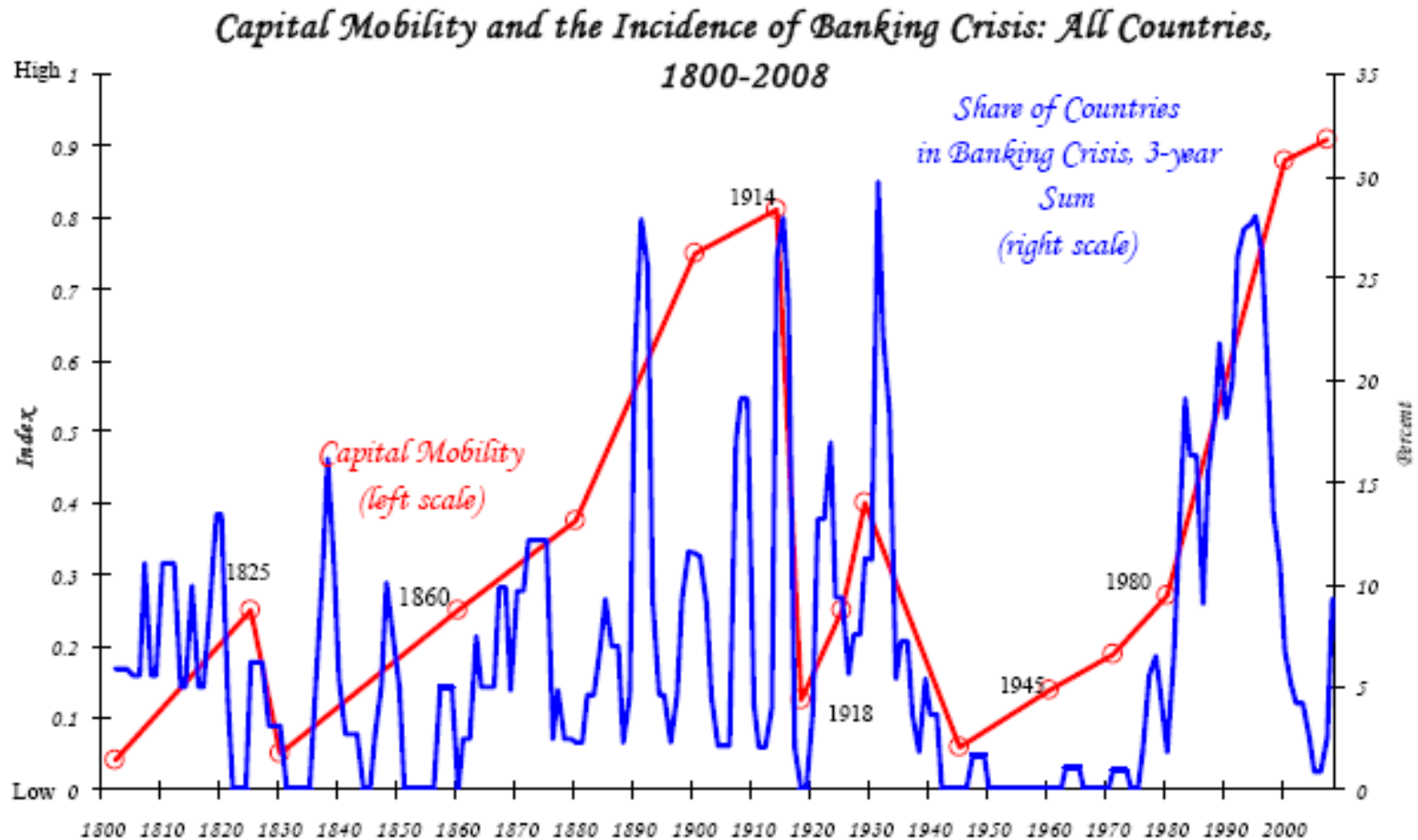
◆ *What protections are given to investors*

- so that they do not flee the financial system?

Governmental responses have varied over the years.

	When to recognize loss?	Who assumes loss?	What protections are offered?
Hoover-Depression 1929-32	Quick	Private	None
Roosevelt-Depression 1933-37	--	Private/ Government	Government guarantee
Latin American Debt Crisis 1981-1989	Delayed	Private/ Government	Government swap of principal
U.S. Thrift Crisis 1984-91	Delayed	Private/ Government	Government guarantee
Japanese Banking Crisis 1981-89	Delayed	Private/ Government	Government guarantee
Nordic Banking Crisis 1987-91	Quick	Private/ Government	Government guarantee

Significant post-Depression restrictions on finance did slash the incidence of banking crises.



Source: Reinhart and Rogoff (2009)

Policy makers often opt to allow institutions to delay recognition of losses.

- ◆ Forbearance, the argument runs,
 - allows banks time to repair their balance sheets and
 - lessens their need to tap markets for funding at a time when they are in disfavor.
- ◆ Forbearance
 - May change the perception of markets about the health of banks,
 - Does not change the understanding of bank managers about losses, and
 - Freezes the market for that asset class, as the stock of legacy assets at banks becomes more valuable sitting on the balance sheet than if resold.

The growth cost of delay

Real GDP growth relative to the world, 1980 to 2008

Percentage points

	<u>Western Hemisphere</u>	<u>Japan</u>	<u>United States</u>	<u>Norway</u>	<u>Sweden</u>
"Lost" years	1981 to 1990	1992 to 2005	1984 to 1991	1987 to 1989	1991
Growth differential in lost years					
Average	-1.7	-2.2	-0.1	-3.1	-2.6
Cumulative	-17.1	-31.5	-0.5	-9.3	-2.6
Growth differential in all other years					
	0.3	0.0	-0.6	-0.1	-1.0

In this crisis, the government

- ◆ Has assumed some of the loss
 - By injecting capital and purchasing underwater assets
- ◆ Has widened the perimeter of the safety net
 - By protecting uninsured claims
- ◆ This enshrines “Too Big to Fail”
 - Which is really “Too Complicated to Fail”
- ◆ The Treasury reform proposal would codify this in law
 - Creating an incentive for financial institutions to stay, or to get, complicated

A practical consequence of this complexity,

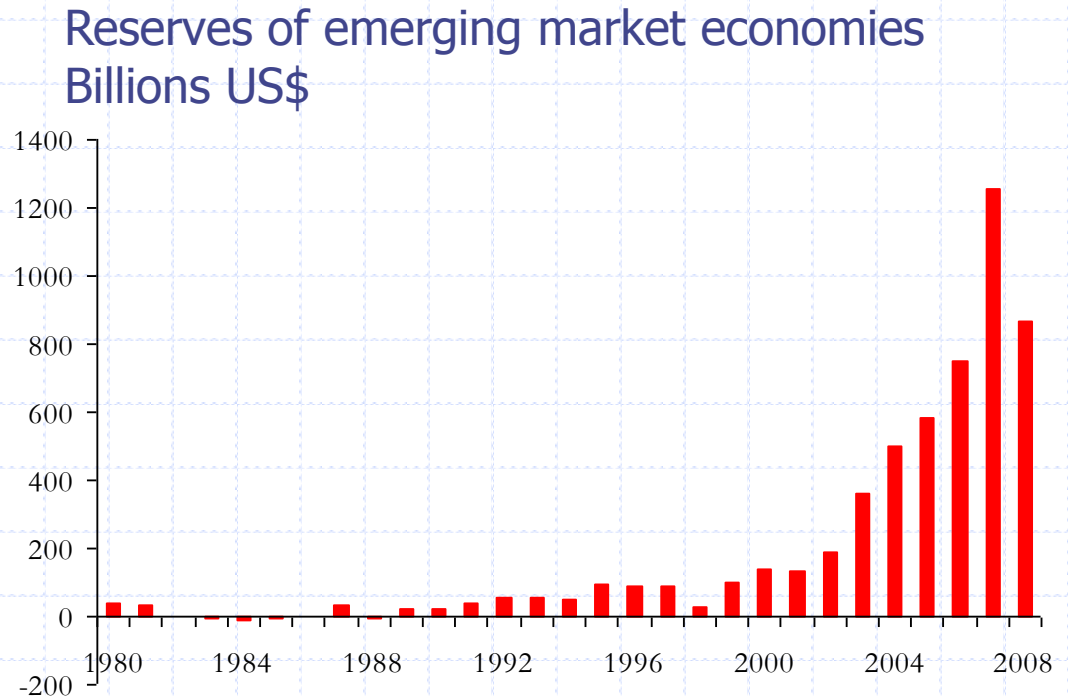
- ◆ From the outside, a Large, Complex Financial Institution (LCFI) is
 - **Hard to supervise**
 - ◆ Leading authorities to miss embedded leverage
 - **Hard for the market to discipline**, lessening
 - ◆ Shareholder oversight of management
 - ◆ Counterparty discipline
 - ◆ Takeover threat
- ◆ From the inside, an LCFI is
 - **Hard for management to supervise**, creating
 - ◆ Incentive misalignments
 - ◆ Suitability problems
 - ◆ Compensation abuses



4. What has been the role of the international sector?

Emerging market economies have been accumulating foreign exchange reserves at a rapid clip

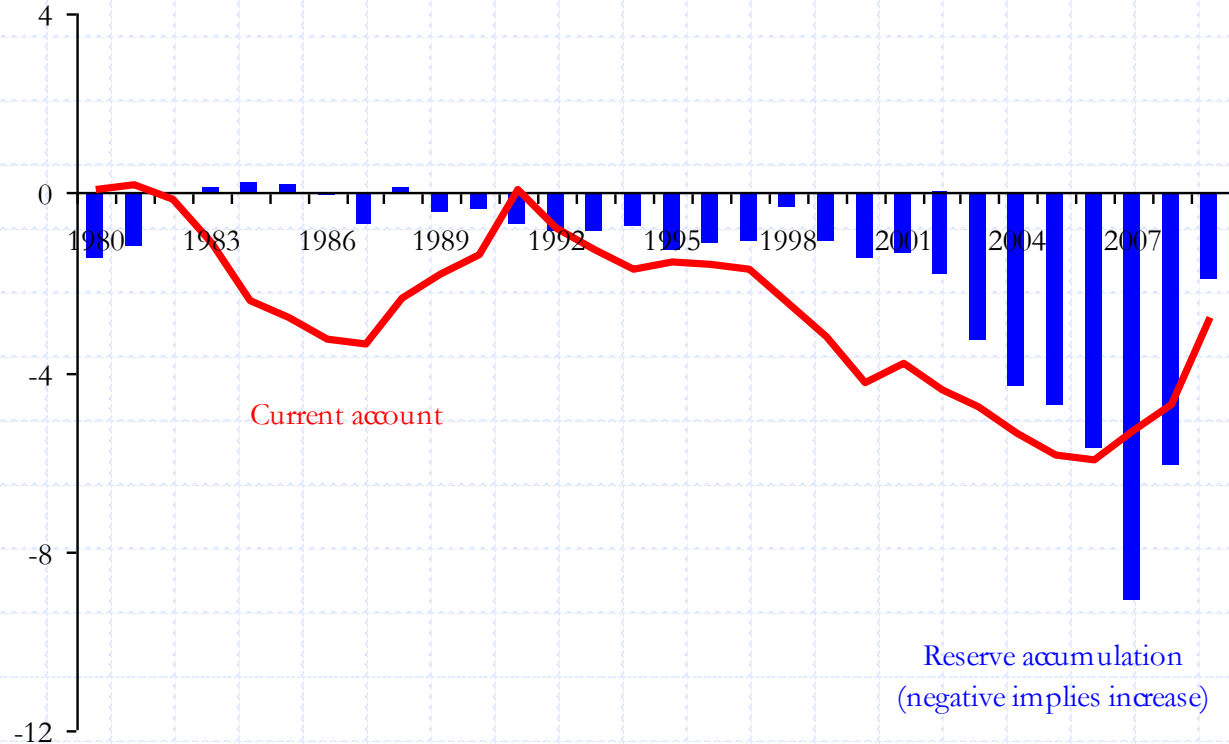
- ◆ To build up a buffer for emergencies
- ◆ To offset upward pressure on the exchange rate as part of the development strategy
- ◆ To diversify given the high saving rate and rapid growth



International capital flows facilitated funding the housing boom

- ◆ As global investors funded the U.S. current account deficit
- ◆ This funding
 - Altered the composition of finance
 - Kept the level of long-term rates low

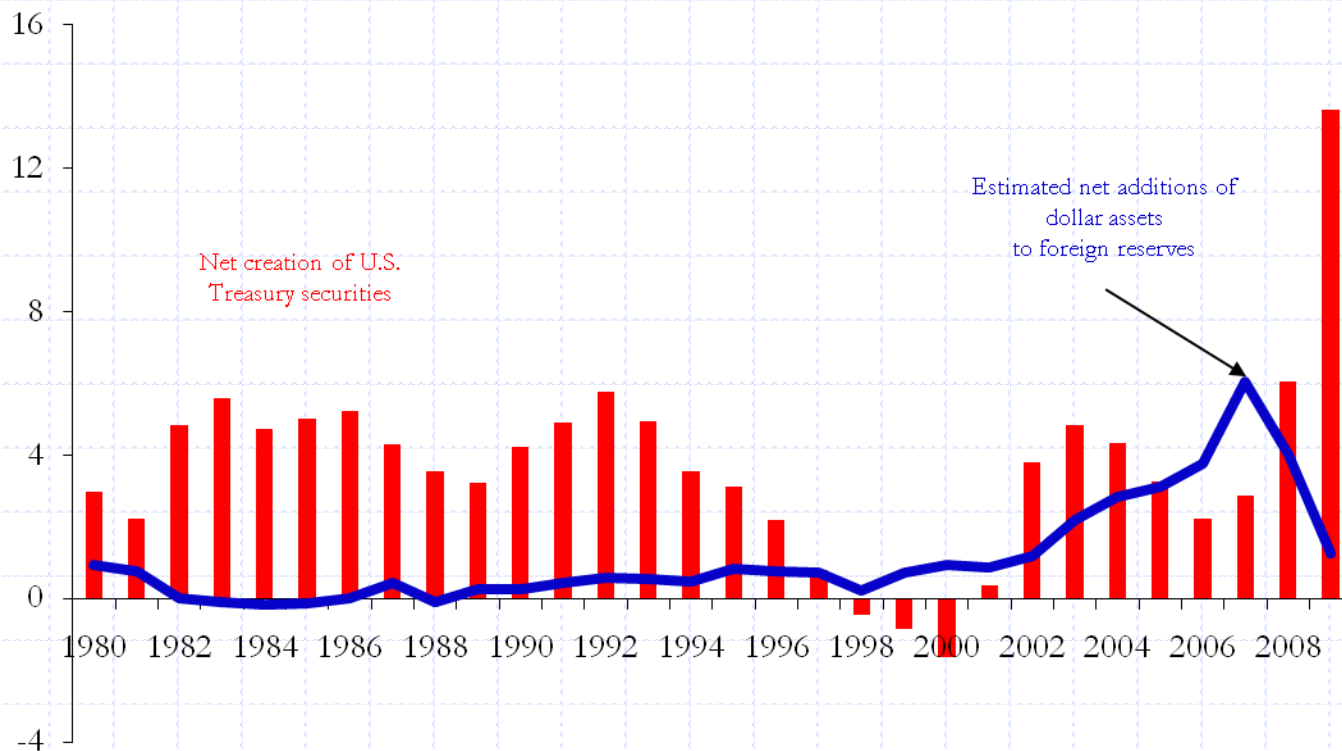
U.S. current account balance and reserve accumulation by emerging market economies
relative to U.S. nominal GDP, percent



Source: International Monetary Fund *World Economic Outlook* (4/09)

Official demand tilted heavily toward government securities

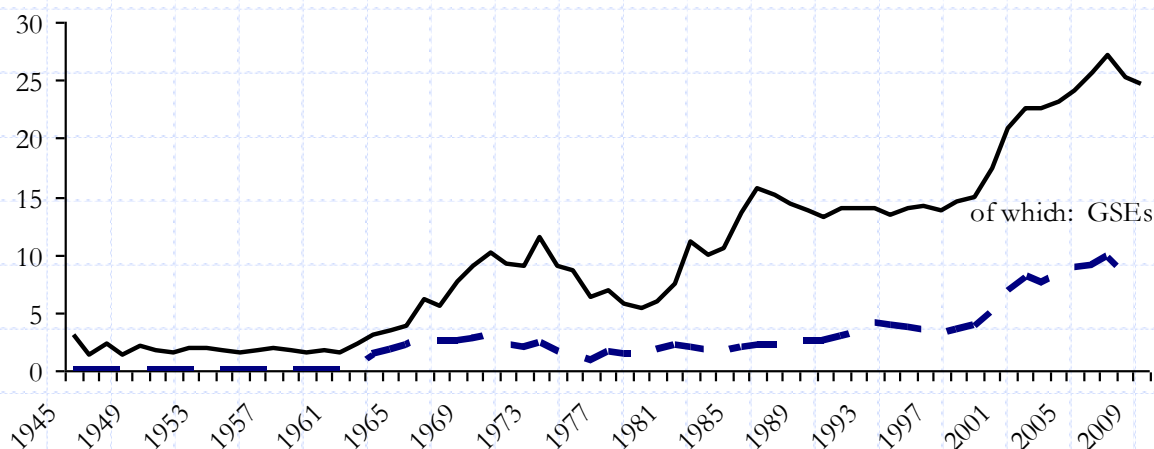
Net creation of U.S. Treasury securities and net additions to foreign U.S. dollar reserves
relative to U.S. nominal GDP, percent



The foreign private sector increased its exposure to U.S. private credit

Foreign exposure to U.S. private credit

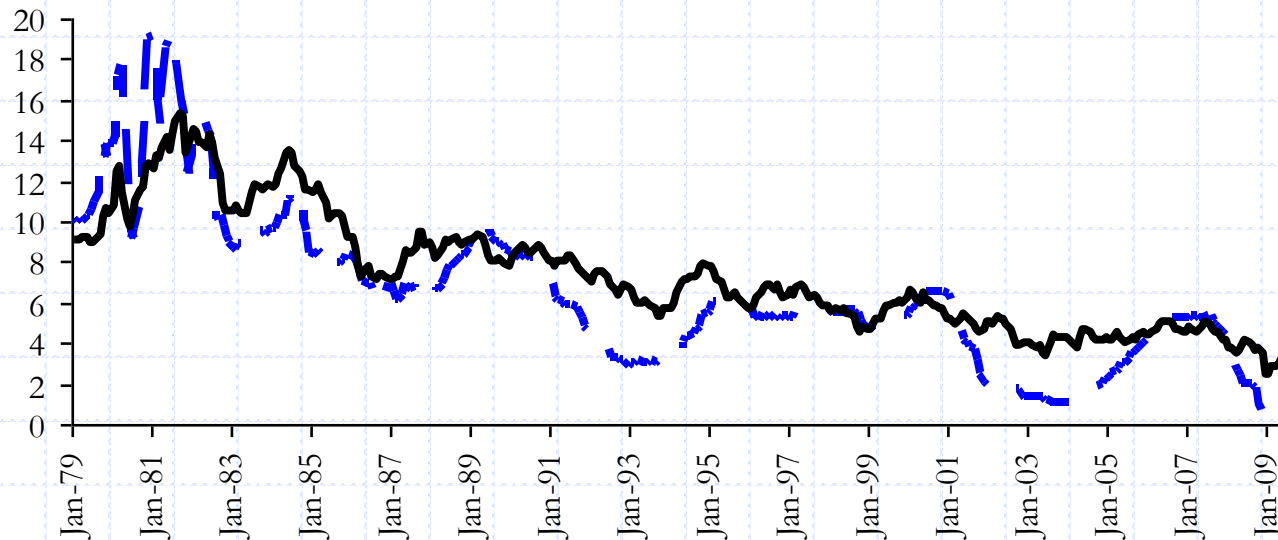
share of total U.S. assets held by the foreign sector, percent



- ◆ Foreign official entities loaded up on Treasuries
- ◆ U.S. financial engineers constructed triple-A exposure to the U.S. for foreign banks
 - Leaving bits and pieces on the cutting room floor

Global saving kept U.S. long-term interest rates low

Fed funds and Ten-year Treasury rates
percent



Source: FRED

...and disconnected from the policy rate

Simple correlation between monthly changes in interest rates

<i>Over the period:</i>	<i>Fed funds rate with:</i>	
	<i>Ten-year</i>	<i>Thirty-year</i>
	<u><i>Treasury</i></u>	<u><i>FRM</i></u>
2/1979 to 12/1987	0.40	0.58
1/1988 to 6/1996	0.34	0.40
7/1996 to 12/2001	0.03	0.13
2/2002 to 12/2006	-0.05	0.13
1/2007 to 6/2009	0.25	0.08

5. How should the Federal Reserve respond to asset prices?

- ◆ Outline the traditional Federal Reserve view on the relationship of asset prices and monetary policy
- ◆ Ask what we've learned

U.S. monetary policy makers followed a basic “syllogism” with regard to asset prices (whether the prices of equity, homes, or foreign currency).

- ◆ Policy should act to offset potential slack or pressure on economy-wide resources.
 - Such preemptive policy making requires making a forecast.
- ◆ Asset prices may be important determinants of current and future spending and pressures on inflation.
- ◆ Therefore, asset prices matter for monetary policy,
 - But they do not loom larger than their direct contribution to the economic outlook.

◆ What this does NOT say:

- A central bank should be indifferent to asset prices.
- Policy makers should not use other available tools (including regulatory powers).
- A central bank should not respond after a bubble bursts.

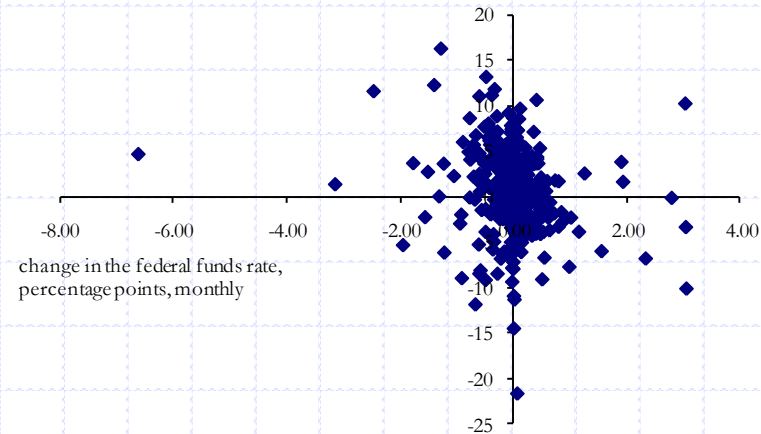
Why? 1. The private sector was supposed to have a comparative advantage over the public sector in pricing and managing assets.

- ◆ Financial market participants devote considerable resources to asset pricing.
 - Central banks do not traditionally have expertise in financial engineering, law, and accounting.
- ◆ What would you do once you've got the asset?
Government ownership
 - Tests the expertise of officials and
 - Leads to political pressure.

Why? 2. Asset prices are complicated and were supposed to be rational.

- ◆ Asset prices have many different moving parts
 - Current earnings
 - Expected future earnings
 - Risk premium
 - Risk-free discount rate
- ◆ Movements in those components have the potential to counter policy action.
- ◆ An action large enough to swamp those potential offsetting effects could have unintended consequences on the economy.

Equity prices and the policy rate
percent change in the S&P500, monthly



Joint behavior of equity prices and the policy rate

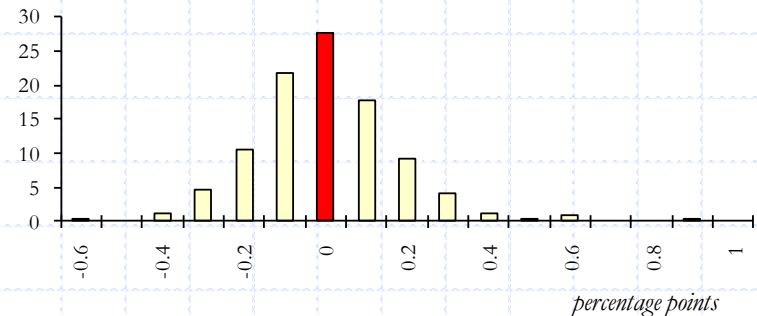
percent occurrence, July 1987 to August 2007

		Federal funds rate	
		decrease	increase
Equity prices	decrease	16%	20%
	increase	34%	30%

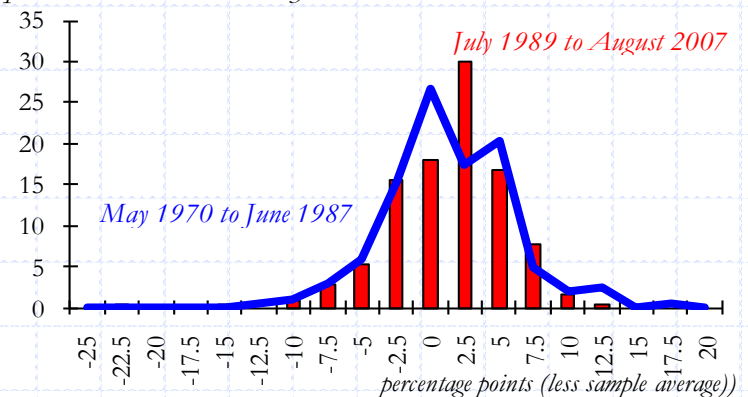
Why? 3. Acting in specific markets might undermine the legitimacy of a central bank.

- ◆ The Federal Reserve Act tells policymakers “to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”
- ◆ Two consequences:
 - There is no obvious rationale for a “preemptive strike” on asset prices.
 - If the economy performs asymmetrically, so too must monetary policy.

Change in the unemployment rate, 1970 to 2007
percent occurrence, monthly



Change in the S&P 500
percent occurrence, monthly



Rescaled to have a mean of zero.

What have we learned about asset prices and monetary policy?

- ◆ Markets do not always get it right
 - The complexity of financial institutions lessens
 - ◆ The effectiveness of supervision
 - ◆ Market discipline
 - ◆ Internal controls
 - Foreign funding can facilitate excesses
- ◆ Cleaning up after the fact can be expensive
 - Crisis management is hard
 - Authorities are slow to acknowledge solvency problems
- ◆ The political impediment to preemptive action remains
 - And may get more severe to the extent that the Federal Reserve's independence is eroded

No way out?

