What the #$%@ is going on?

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Outline

- Bubbles
- Monetary Policy
- Fiscal Policy
- Lessons from Europe and the States
Disclaimers

- It is indeed impressive how rapidly the economists who failed to predict this crisis — or predicted the wrong crisis (a dollar crash) — have been able to produce such a satisfying story about its origins.
  - —Niall Ferguson, NY Times (15 May, 2009)

- If I really knew, would I tell you?

- You get what you pay for.

- Blame Townes
Credit without blame: ideas and slides stolen from clear thinkers

- Art Laffer, Ford Scudder, Tom Landstreet
  - Laffer Associates
- CalculatedRisk.blogspot.com
- David Parsley
  - Vanderbilt University
- Jon Shayne
  - aka “Merle Hazard”
- Bill Spitz
  - Former Treasurer, Vanderbilt University
Bubble-ology: how do bubbles inflate?

- If prices are expected to rise
  - Buyers accelerate purchases (demand increases)
  - Sellers delay sales (supply decreases)
  - Both cause price to rise
  - ➔ Self-fulfilling expectations

- If prices expected to rise faster than rate of interest, then
  - Borrow as much as you can, ...
    - ...in order to buy as much as you can
**Bubble-ology: how do bubbles deflate?**

- If prices are expected to fall
  - Buyers delay purchases (demand decreases)
  - Sellers accelerate sales (supply increases)
  - Both cause price to fall

- ➔ Self-fulfilling expectations

- Negative real interest rates
  - Put your money in a mattress
  - Keynes called this a “liquidity trap”
  - “animal spirits?”
Bubbles emerge at times when investors profoundly disagree about the significance of a big economic development, such as the birth of the Internet.

Once they get going, financial bubbles are marked by borrowing, and big increases in trading.

Only when skeptical investors act simultaneously -- a moment impossible to predict -- does the bubble pop.
Big Economic Event
Profound Disagreement

• Housing prices increased dramatically, especially where supply was limited (zoning)

  • **David Lereah** believed the house price increase could be explained rationally – low inventories, low mortgage rates, and favorable demographics caused by a big increase in boomers and retirees, who often buy second homes.

  • **Robert Shiller** was wary of a bubble. He identified the bubble by noting that house prices were becoming very expensive relative to rents.
How do you recognize a bubble?

Price-to-Rent Ratio, LoanPerformance HPI and BLS Owners' Equivalent Rent

Jan-83, Jan-84, Jan-85, Jan-86, Jan-87, Jan-88, Jan-89, Jan-90, Jan-91, Jan-92, Jan-93, Jan-94, Jan-95, Jan-96, Jan-97, Jan-98, Jan-99, Jan-00, Jan-01, Jan-02, Jan-03, Jan-04, Jan-05, Jan-06, Jan-07, Jan-08, Jan-09, Jan-10, Jan-11

Price-to-Rent Ratio, Jan 2000 = 1.0

0.0, 0.2, 0.4, 0.6, 0.8, 1.0, 1.2, 1.4, 1.6, 1.8

0.0, 0.2, 0.4, 0.6, 0.8, 1.0, 1.2, 1.4, 1.6, 1.8
How do you recognize a bubble?

Price/Earnings Ratio of U.S. Stocks, 1881-2010
(Using 10-Year, Inflation-Adjusted Earnings)

Effects of bubble mis-pricing

- High real estate prices caused over-construction of housing

- High securities prices caused over-production of securities
  - High asset prices imply small risk premia $\rightarrow$ investors not compensated for bearing risk.
Burst bubbles are different from ordinary recessions

- Rogoff and Reinhart, “this time is different”
  - “recessions that follow in the wake of big financial crises tend to last far longer than normal downturns”
  - “…output may take four years to return to its pre-crisis level. Unemployment will continue to rise for three more years, reaching 11–12 percent in 2011.”
    - Prediction made in March, 2009.
Christine Romer’s forecast

Unemployment Rate With and Without the Recovery Plan

- September ’09
- May ’09
- December ’09

Maroon dots are actual unemployment data
Everything in blue was created by Obama’s economic team
http://innocentbystanders.net
Effects of burst bubble: Jobs

Employment Population Ratio and Recessions

Recession
Employment-Population Ratio

http://www.calculatedriskblog.com/
What should we do when a bubble pops?

- Don’t repeat the mistakes of the Great Depression.
  - Tight monetary policy made things worse.

- “Loose” monetary policy
  - Guarantee commercial paper
  - Short-run rates near zero
    - Traditional Fed tool
  - Long-run rates kept down by “quantitative easing”
    - Buying mortgage-backed securities
  - Excess reserves in system, but no demand for loans
    - “pushing on a string”
What about fiscal policy?

Two flawed models: markets vs. Keynes

Markets cannot explain involuntary employment

Keynes explained unemployment with sticky wages (unemployment results if wages don't fall when demand falls)

- Policy: Increase demand to increase employment

But Keynes model is incomplete: what happens when you pay for the stimulus

- Does it merely borrow consumption from the future?

10-yr expected inflation as derived from the 10-yr Treasury note and the 10-yr TIPS has fallen of late, but is still significantly elevated from its lows Fall 2008 lows.
What about fiscal policy?

- The ongoing battle between dead economists with incomplete models

Keynes: If wages don’t fall when demand for labor falls, then you get excess supply (involuntary unemployment)
  - Policy: stimulate economy to increase demand

Classical view of markets cannot explain involuntary unemployment
  - Policy: wait for wages to adjust, and avoid policies that slow adjustment (like unemployment insurance)
 Didn’t WWII “stimulus” pull us out of Great Depression?  
  ◦ Do we need a much bigger stimulus?

But Rogoff & Reinhart find that Developing countries recover faster from crises because wages fall very fast.  
  ◦ Policies that slow adjustment are counter–productive

And where do the stimulus funds come from?  
  ◦ What if you run out of borrowing capacity?  
    • US vs. Germany

And someone has to decide how to spend the stimulus  
  ◦ Return of “industrial policy” to pick winners.  
    • Losers: France Minitel, Heavy–water reactors, British Leyland, US corn–based ethanol  
    • Winners: US Internet, Lockheed
Why didn’t Bush Tax Rebate work?

Does consumption come from permanent or transitory income?
Keynesian Stimulus: Targeted?
1st Time Home Buyer’s Tax Credit

MBA Purchase Applications Index

- Purchase Index
- 4 Week Moving Average

http://www.calculatedriskblog.com/
Cash for Clunkers

Retail Automobile Sales
Motor Vehicle Dealer Sales, Seasonally Adjusted, $ Millions

source: US Census Retail Trade Report, http://www.census.gov/retail/#mrts
category 4411 and 4412
Is EU nearing limit of their borrowing ability?

- Milton Friedman: “EU will not survive recession”
  - EU’s "disciplinary action" against France, Spain, Malta, Greece, Latvia and Ireland could result in fines.
  - Greece and Portugal have been fined but never paid a penny
European Bond Spreads
Basis points, 10-year bond spread to German bonds

Source: Bloomberg

EU/IMF/ECB policy response
Greece vs. Italy

- Greece borrowed heavily using what amounted to “other people’s money.”
  - Does EU need fiscal authority to go with monetary union?

- Italy’s problem is growth, not debt, due to its fear of competition
  - Tenure for employees of all but smallest firms
    - Hiring is costly
  - Protectionist impulses of guilds
    - 1000 euros for a notary public
  - Italy survives due to a huge black market (>25%)
Is Ireland’s austerity the answer?

- Economy shrank 7.1 percent last year
- Joblessness above 13 percent
- 14.3% budget deficit.

But would it have been worse without austerity?
Lessons from California?

- The "old" pro-growth coalition gave way to the "new" progressive coalition of labor unions, anti-growth "greens," and minorities and liberals, who want more social spending.
  - ➔ tax increases and public sector expansion:

  - In 1975, “Jerry” Brown, Jr.,... scuttled infrastructure spending, in large part because of his opposition to growth and concern for the environment.

  - 1978 Dill Act legalized collective bargaining for public-employee unions

- DISCLAIMER: I voted for Governor Brown, several times
Lessons from Sweden?

- If we are to have a European style welfare state, let’s run it efficiently
  - Reduced tax rates and deregulation of the early 1990s
  - Vouchers instead of subsidies
    - voucher program saved the country’s educational system.
    - Paul Ryan (R. WI): healthcare vouchers
  - Outsource budgetary decisions to independent councils with mandate to preserve fiscal solvency
    - Jim Cooper (D. TN)
  - Avoid bailouts: in 2009, GM threatened to close Saab
    - “We are very disappointed in G.M., but we are not prepared to risk taxpayers’ money. This is not a game of Monopoly.”
Do you have a Plan B?

“The American Republic will endure until the day Congress discovers that it can bribe the public with the public's money”

Alexis de Tocqueville, 1835