

# Not (Yet) a Minsky Moment

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# What Happened?

- Ex ante (predictably) imprudent lending and imprudent pricing and rating of risks.
- Subprime credit collapse
- MBS => CDO => LSS => ABCP
- ABCP and SIVs => Banks, MMMF, IBs
- Bear Stearns had 33 to 1 gearing, financed with overnight repos, opaque and illiquid assets many of which were connected to subprime shocks (it was not insolvent on March 17, but one cannot maintain access to money markets at elevated levels of risk).
- Libor elevated (adverse selection costs)
- Higher default risk pricing
- Collapse of confidence in securitization
  - Ratings agencies underestimated risks
  - Agency problems of brokers, banks, ratings

# Figure 1: Annual Cash CDO Issuance

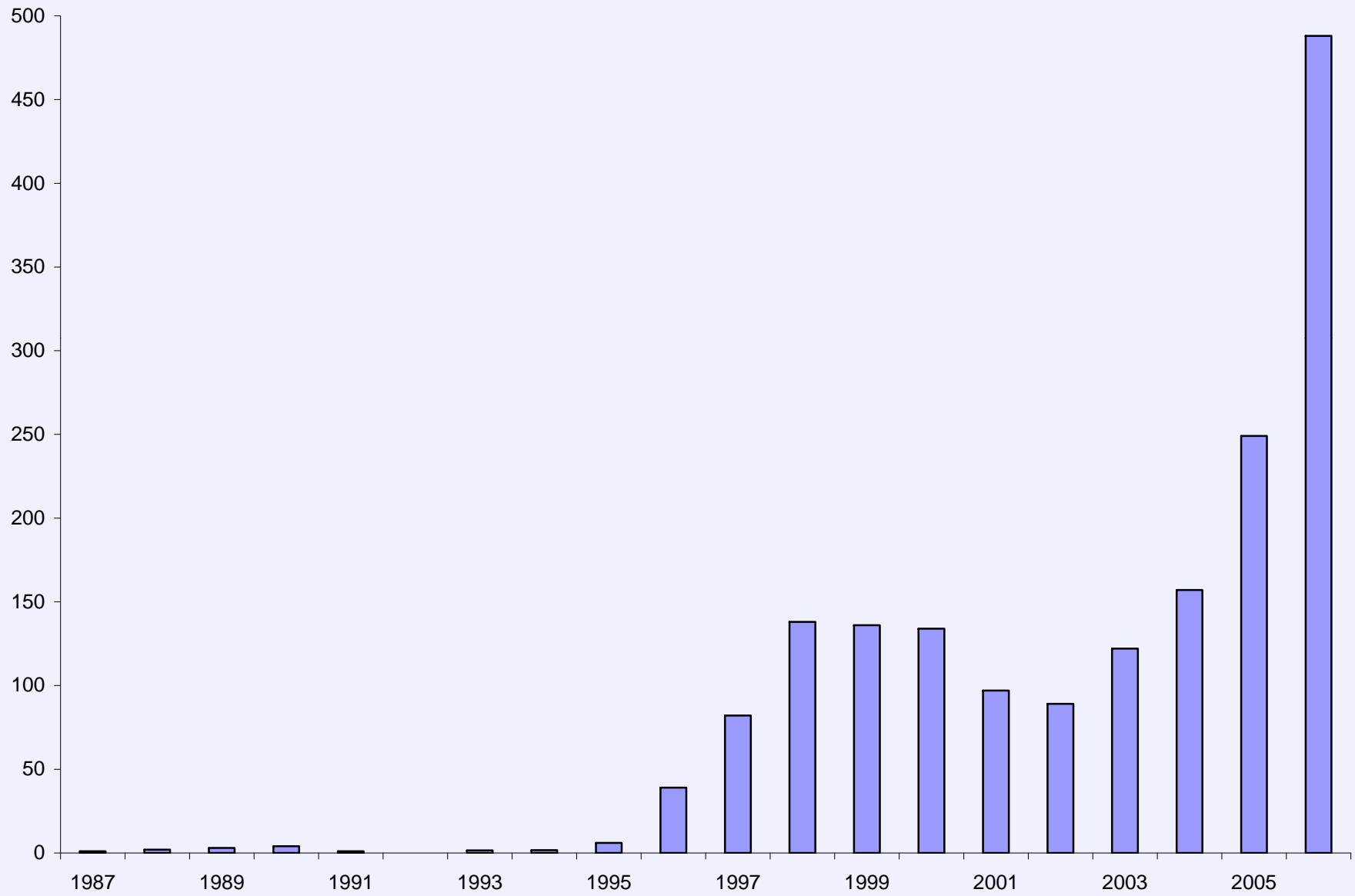
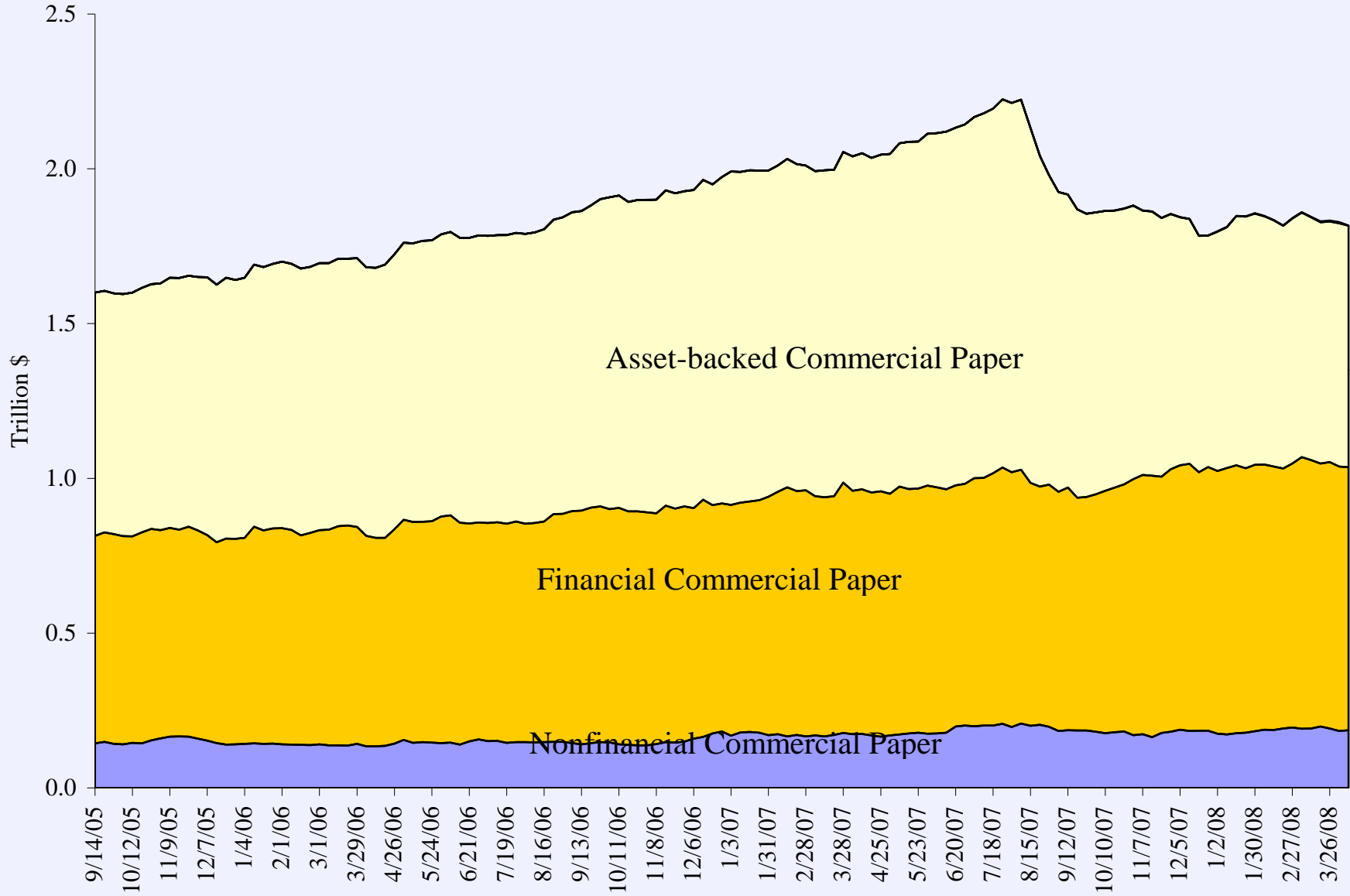
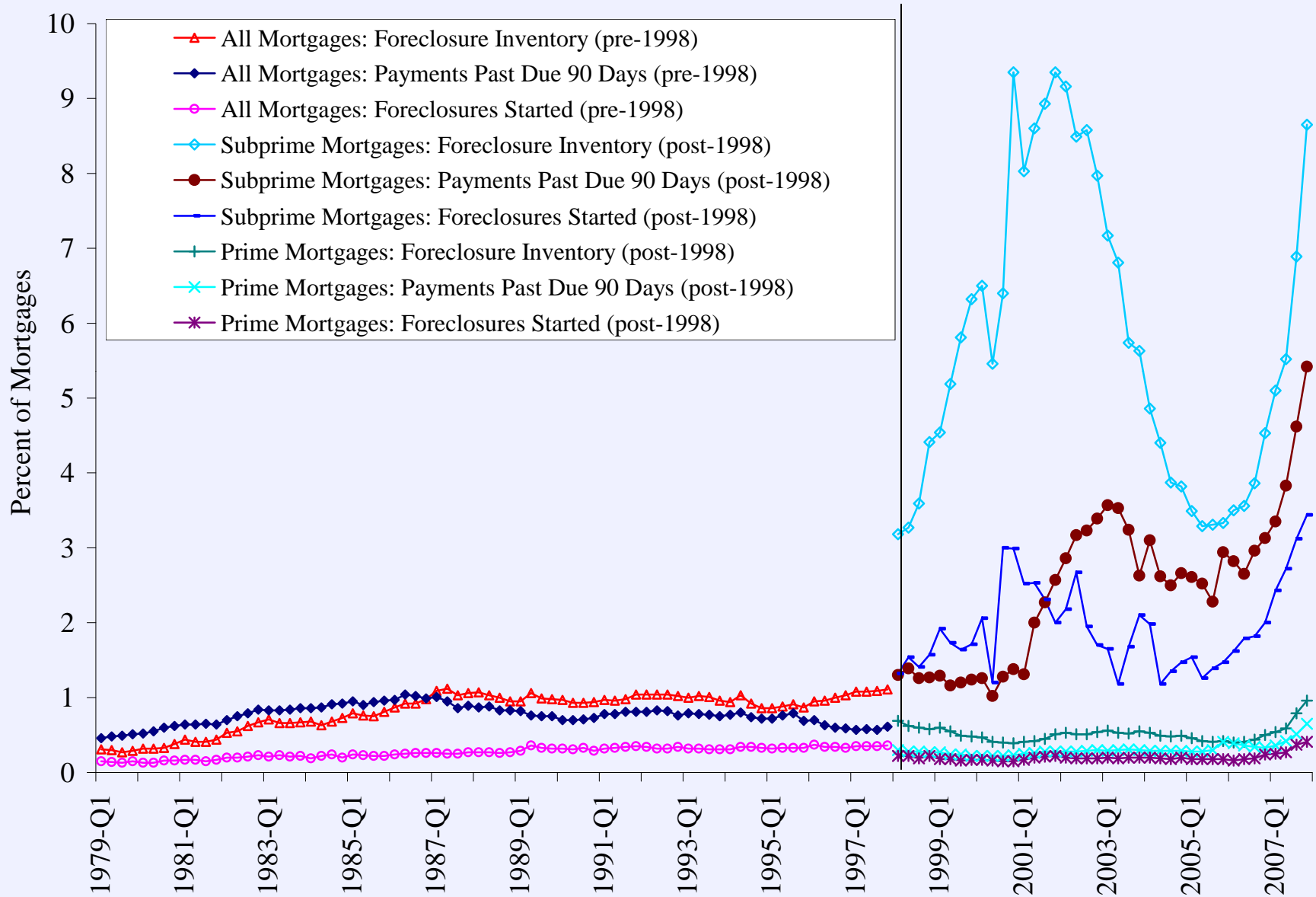


Figure 9: Commercial Paper Outstanding (Weekly, Seasonally Adjusted)



# Why did this happen?

- Peak of subprime foreclosure rate, by some measures, was over six years ago! Why did issuance and use in securitization accelerate?
- Losses then were small, owing to rapidly rising home prices, and ratings agencies built optimistic LGD into scenarios. That was idiotic, and produced a doubling of originations of subprime from 2003 to 2005.
- Novelty of CDOs, LSSs, SIVs, combined with grade inflation by ratings agencies (what does BBB mean?), and fee-driven incentives likely produced confusion about true risk.
- High liquidity and low yields, along with a long period without turmoil encouraged money managers to search for high yields and underestimation of risk (agency?).
- This sort of myopia is, indeed, Minskyesque! But a true Minsky moment is more – a financial crisis that produces a severe macro decline. Will this happen?



# Macroeconomic Consequences?

- Financial system and credit supply
  - Banks and others must absorb losses, reintermediate lending, raise capital to expand capacity to grow, as needed; if the capacity of banks to supply credit, and the capacity of firms to raise credit directly, is inadequate, then it is possible to experience a severe credit crunch like 1989-91.
  - Elevated Libor spreads mean that monetary policy must lower Fed funds more than it would otherwise have to, in order to keep market interest rates from rising.
  - Higher credit spreads are inevitable, but if they remain exaggerated on the positive side could discourage borrowing.
- Housing prices
  - If housing was in a bubble that just burst, prices could fall dramatically; any collapse in credit affecting housing and/or consumers could aggravate that decline.
- Economic activity
  - The combination of a credit crunch, and the wealth effects of housing price declines on consumption, could tip us into a recession.

# Financial System and Credit Supply

- This is not 1989-91.
  - Banking system condition is good (losses will likely amount to two missing quarters of earnings in the worst case, which is Citi).
  - Large losses are being recognized quickly, and loans are being reintermediated quickly (banks are absorbing securitizations on the balance sheet).
  - Liquidity risks of ABCP and SIVs are now reasonably contained for US banks.
  - Banks are much better diversified (due to deregulation), and shocks are not as concentrated in banks this time.
  - Banks are not having trouble raising tier 1 capital (predictably in the form of preferred as well as common).
  - Fed is responding aggressively to Libor spread problem, both in fed funds rate cuts and in unprecedented discount window operations.
  - Corporate balance sheets are strong (dividend tax cut) and there is lots of financial slack and corporate liquidity.

Figure 18: Commercial and Industrial Loans

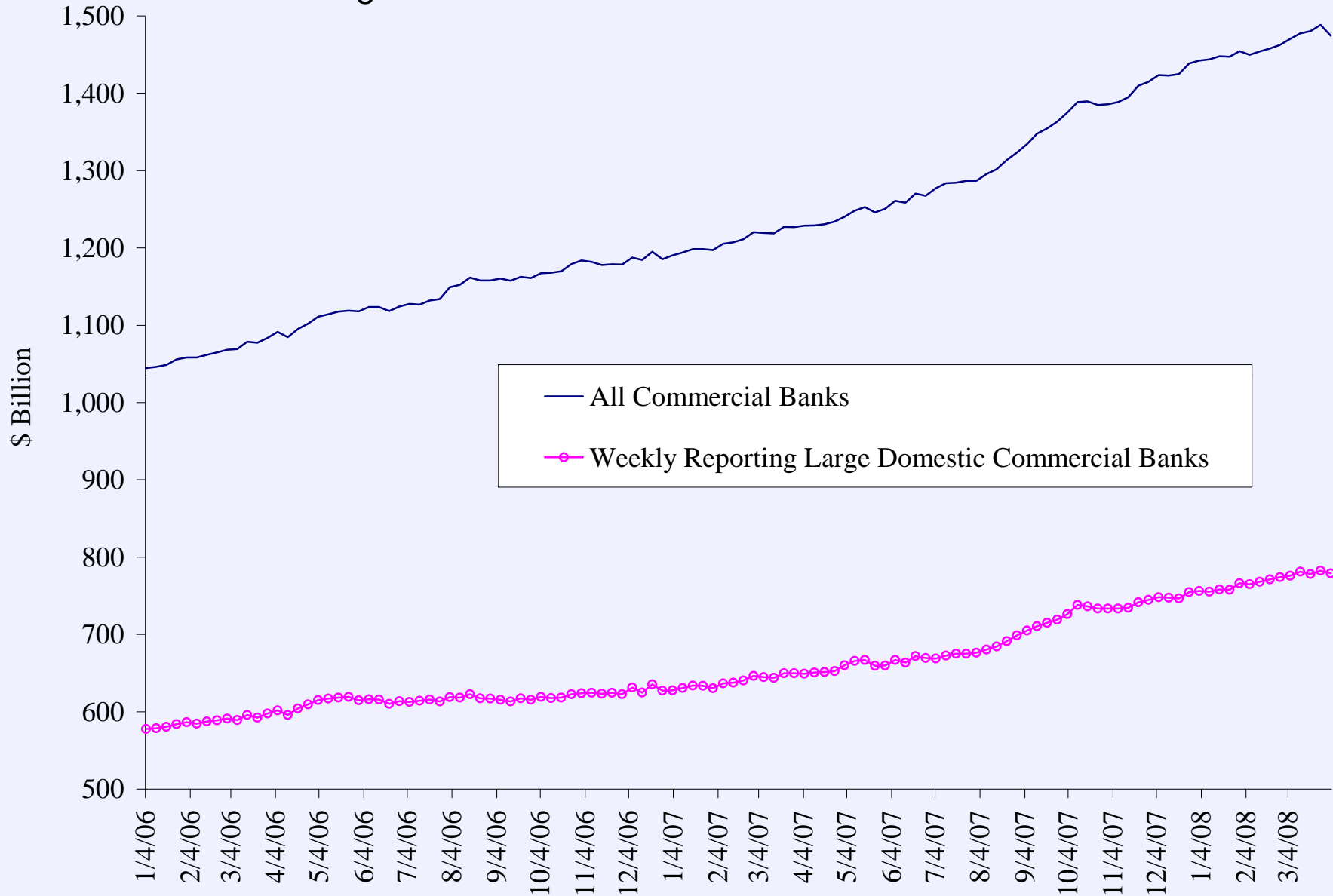


Figure 10: Commercial Paper Rates, LIBOR, and Mortgage Rates

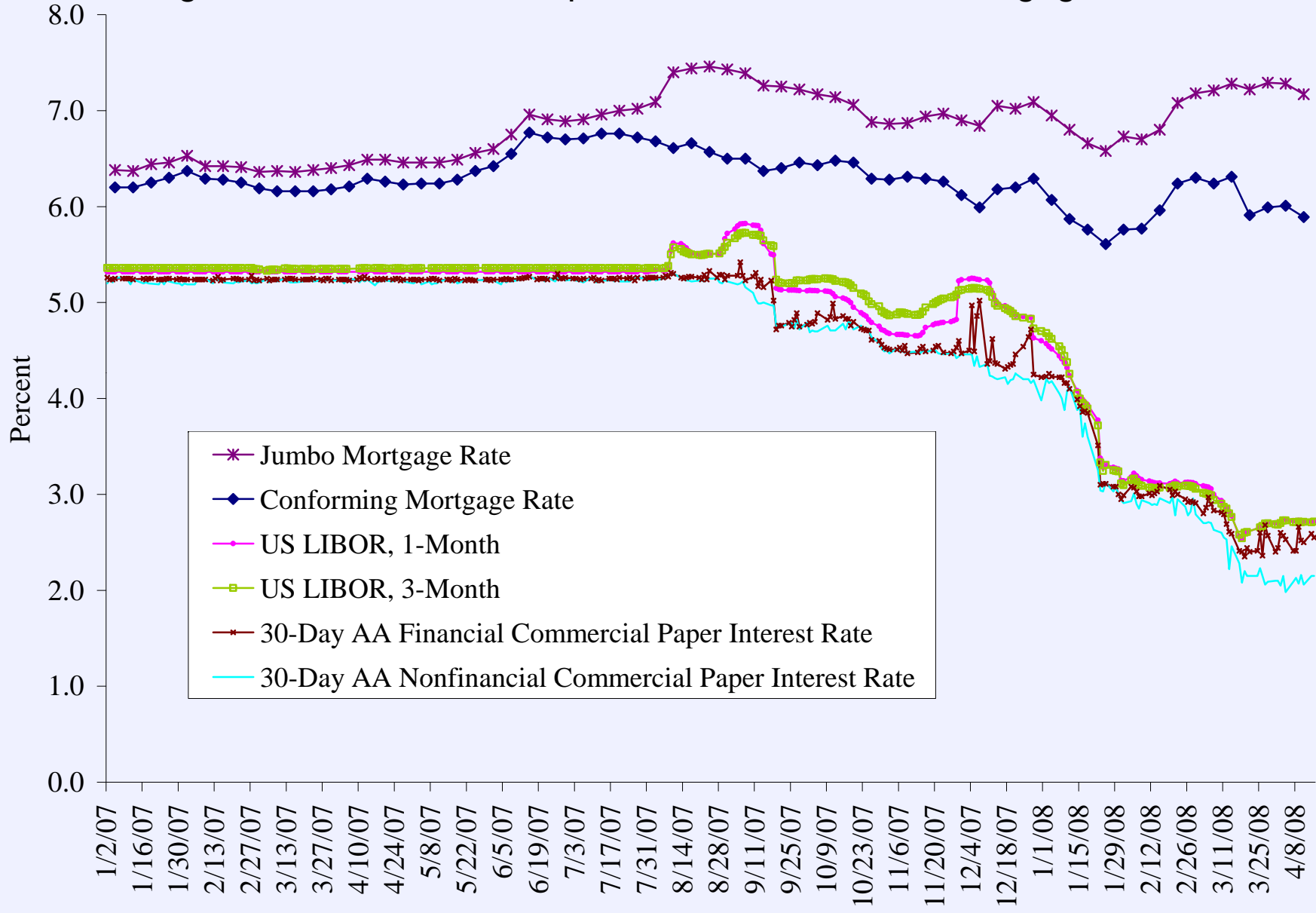
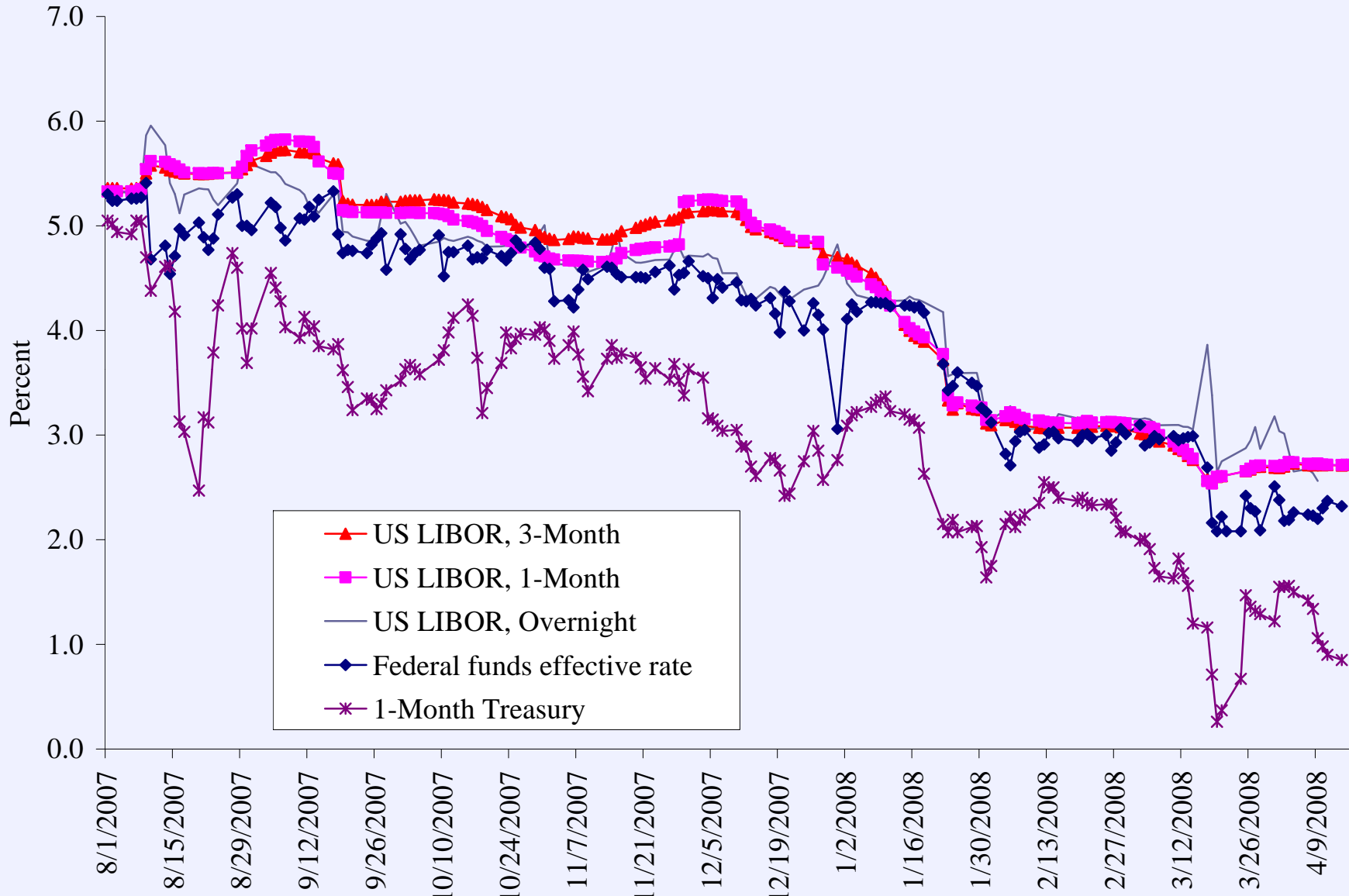


Figure 12: LIBOR, Treasury Bill, and Fed Funds Rates



### Real Fed Funds Rate

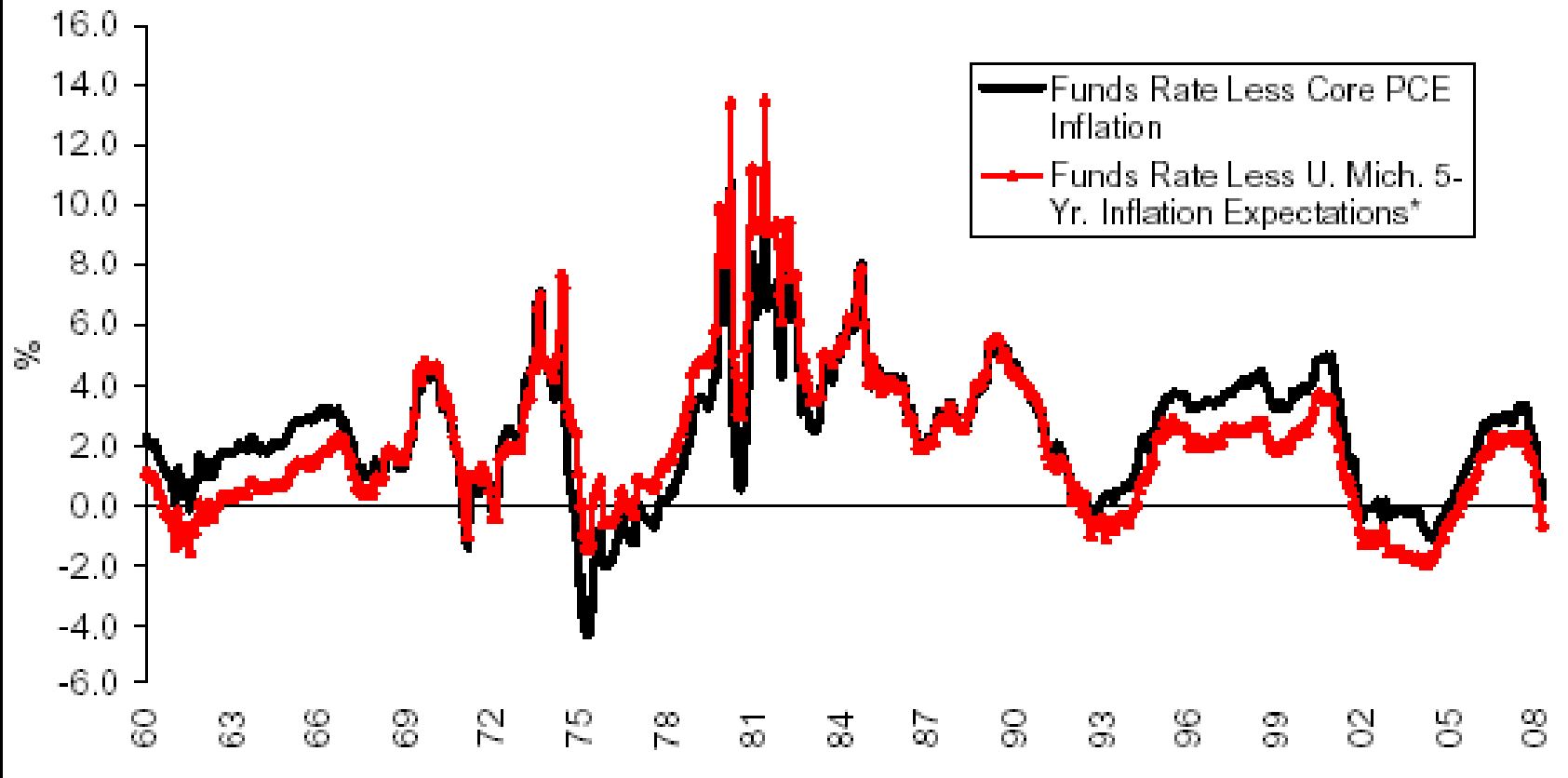


Figure 13: Overnight Libor-Fed Funds Spread

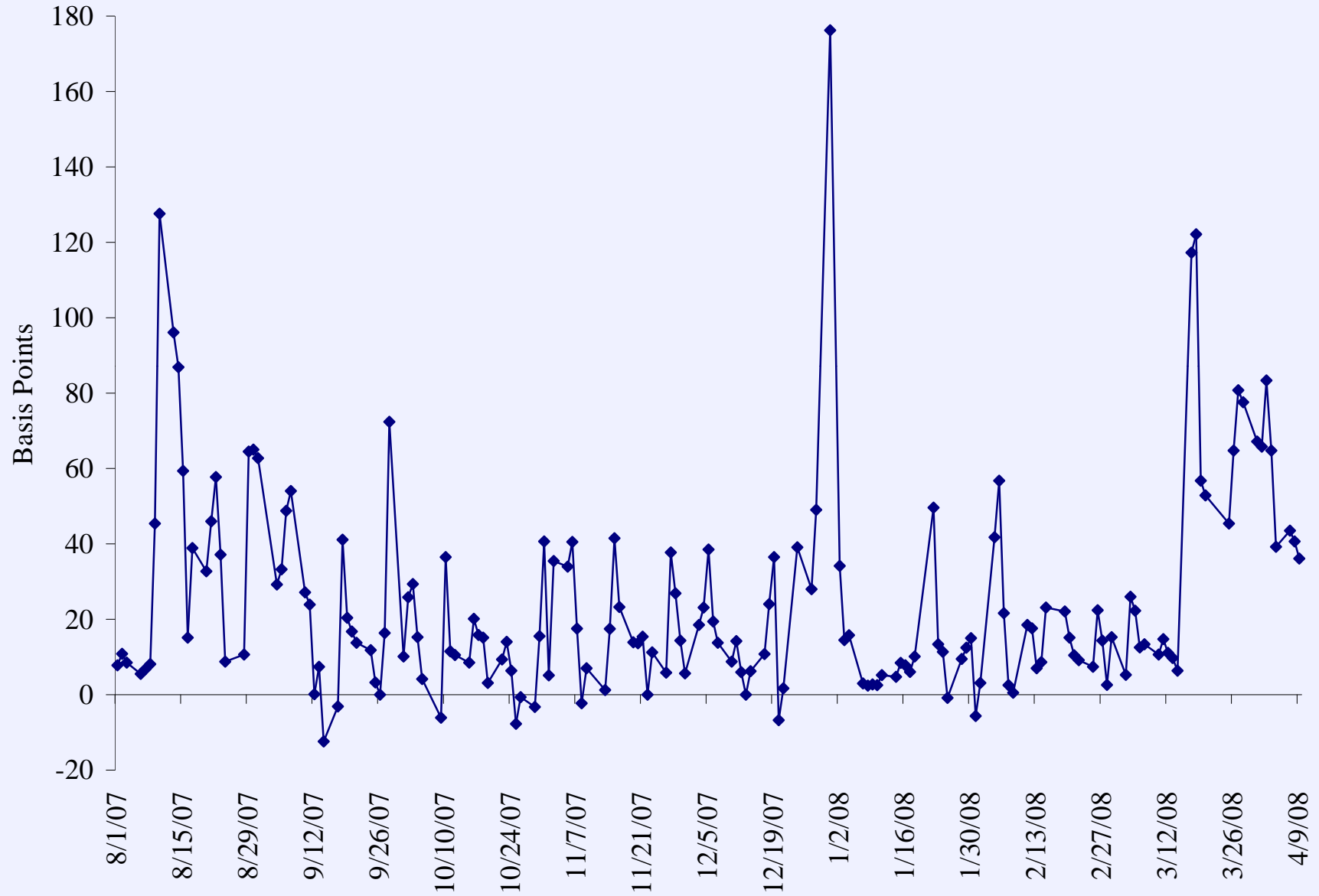
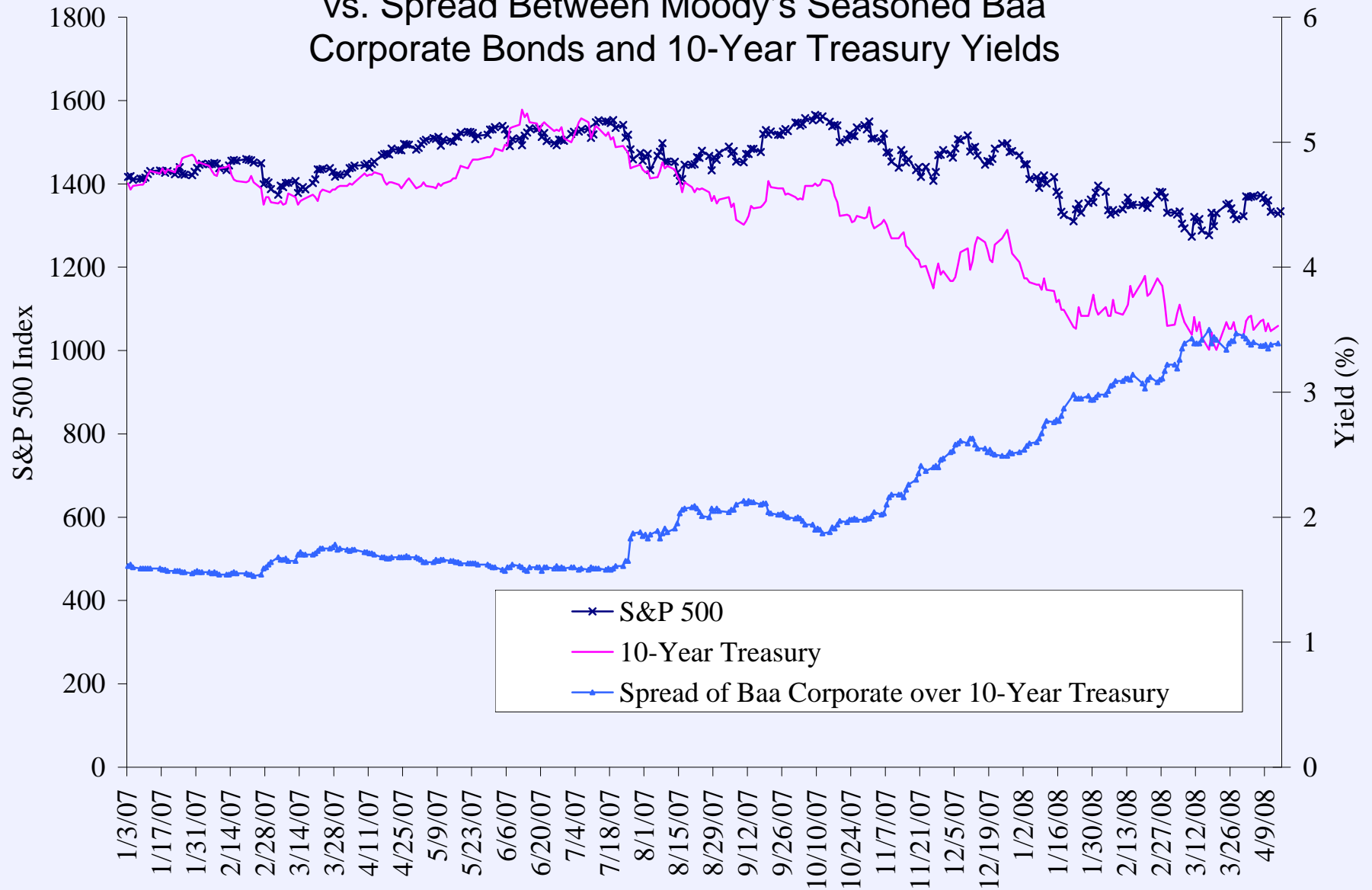


Figure 14: S&P 500  
 vs. 10-Year Treasury Yields  
 vs. Spread Between Moody's Seasoned Baa  
 Corporate Bonds and 10-Year Treasury Yields



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4-IN-1 GRAPH

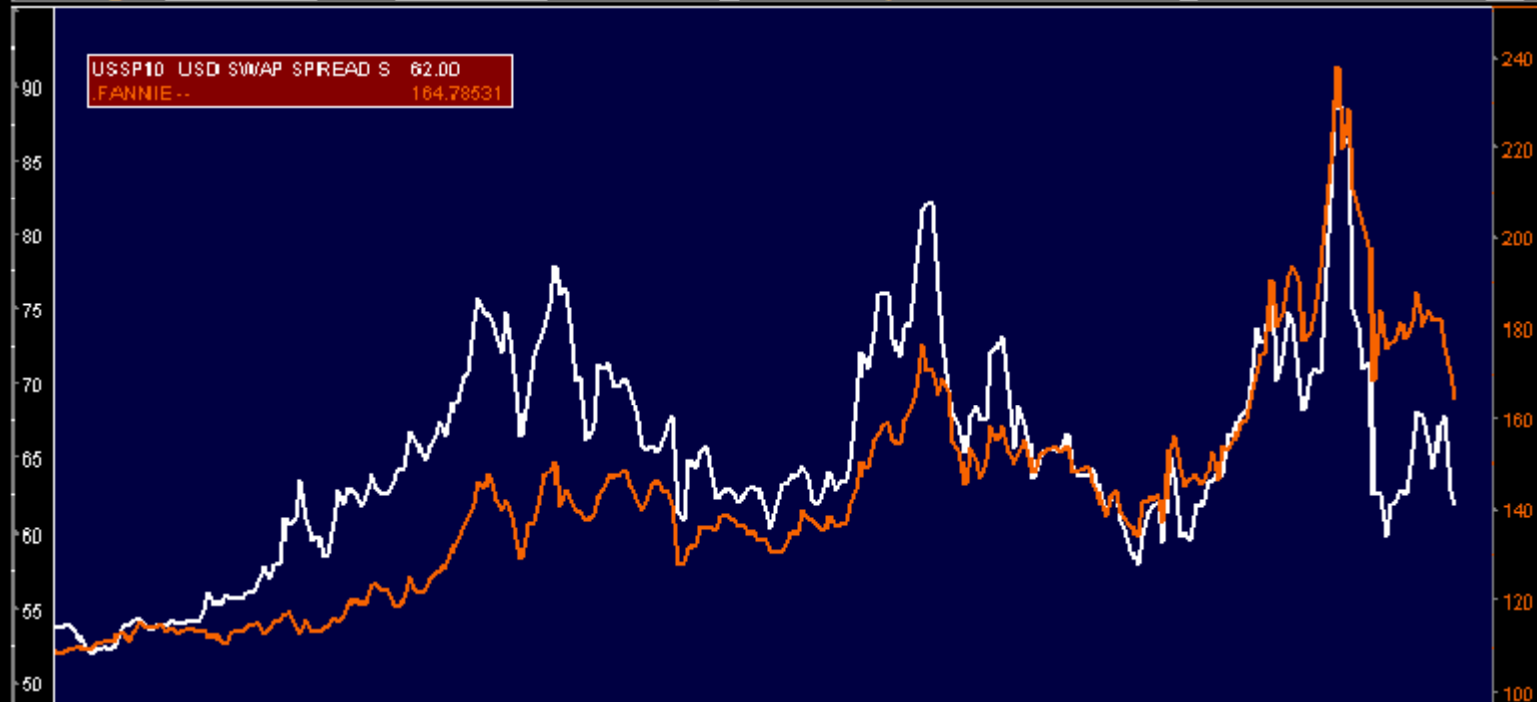
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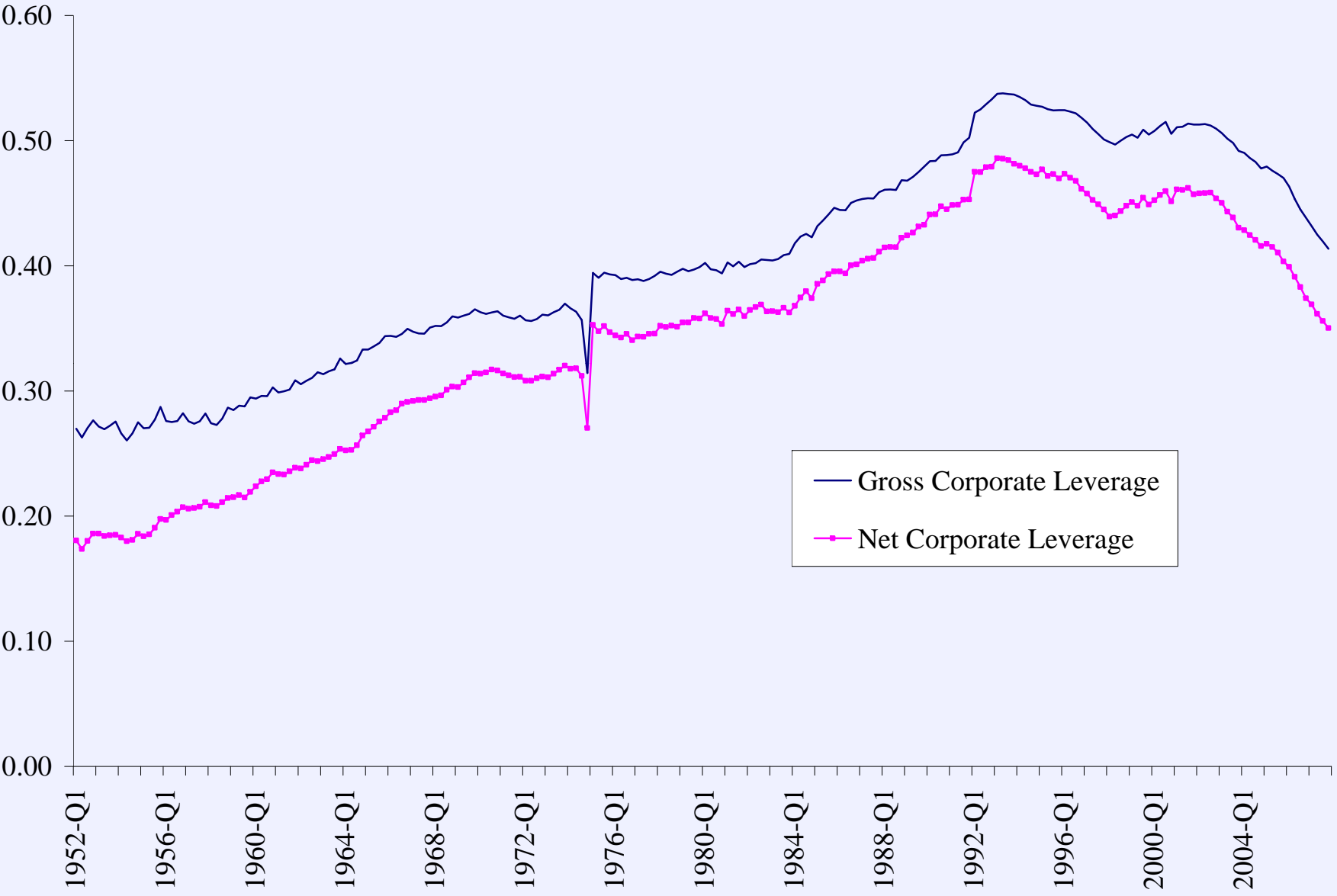
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1	USSP10	USD SWAP SPREAD	SPx1		2	.FANNIE --	Px1				
3			Px1		4		Px1				
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091623	01081522	01081522	02081623	01081522	031017	01081522	01081522	03101724	01081522	01081522	03101724	0108										
	2007 May	2007 Jun	2007 Jul	2007 Aug	2007 Sep	2007 Oct	2007 Nov	2007 Dec	2008 Jan	2008 Feb	2008 Mar											
Australia	61	2	9777	8600	Brazil	5511	3048	4500	Europe	44	20	7330	7500	Germany	49	69	9204	1210	Hong Kong	852	2977	6000
Japan	81	3	3201	8900	Singapore	65	6212	1000	U.S.	1	212	318	2000	Copyright 2008 Bloomberg Finance L.P. H321-786-0 07-Apr-08 7:23:20								

Figure 15: Corporate Leverage



# Housing Prices

- Perceptions are based on flawed data (median sales prices, or Case-Shiller index)
- There was no national housing bubble. The bubble was confined to a few locations, which are now troubled (Florida, Arizona, Nevada, parts of California). Other troubled spots have been in secular housing decline (Ohio and Michigan).
- Housing sales are way down, but this is true even in persistently booming markets (Seattle and Austin), and reflects a pause in buying, I believe, for the dust to settle. In the Spring, sales are likely to grow (they already have). There is no existing evidence in the literature of strong predictive content of sales for prices.
- Housing has already been in a recession for a year.
  - This has reduced starts, which going forward will provide some support for housing prices.

Figure 2: U.S. Home Price Appreciation

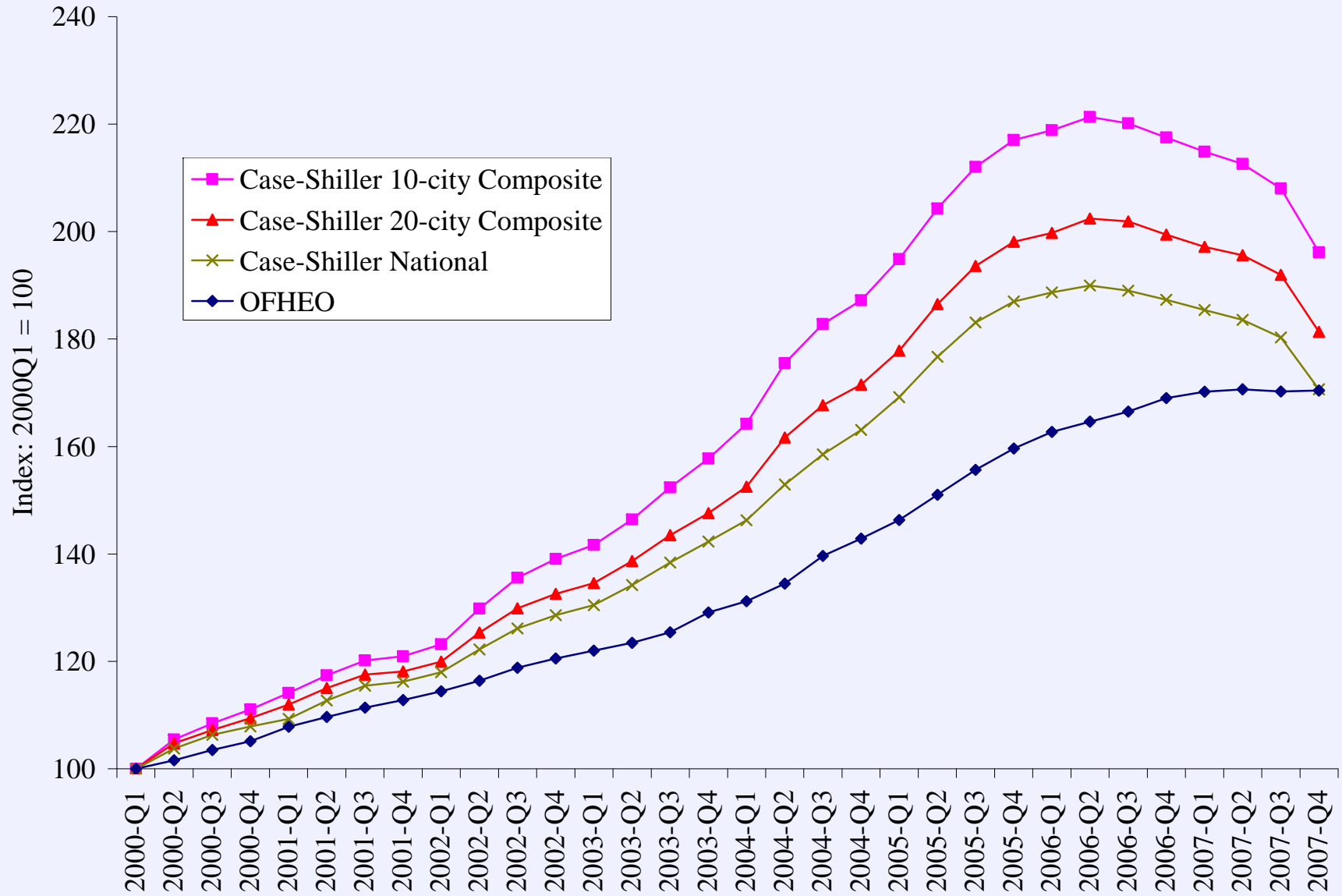


Figure 3: OFHEO HPI  
Disaggregated by Case-Shiller Coverage

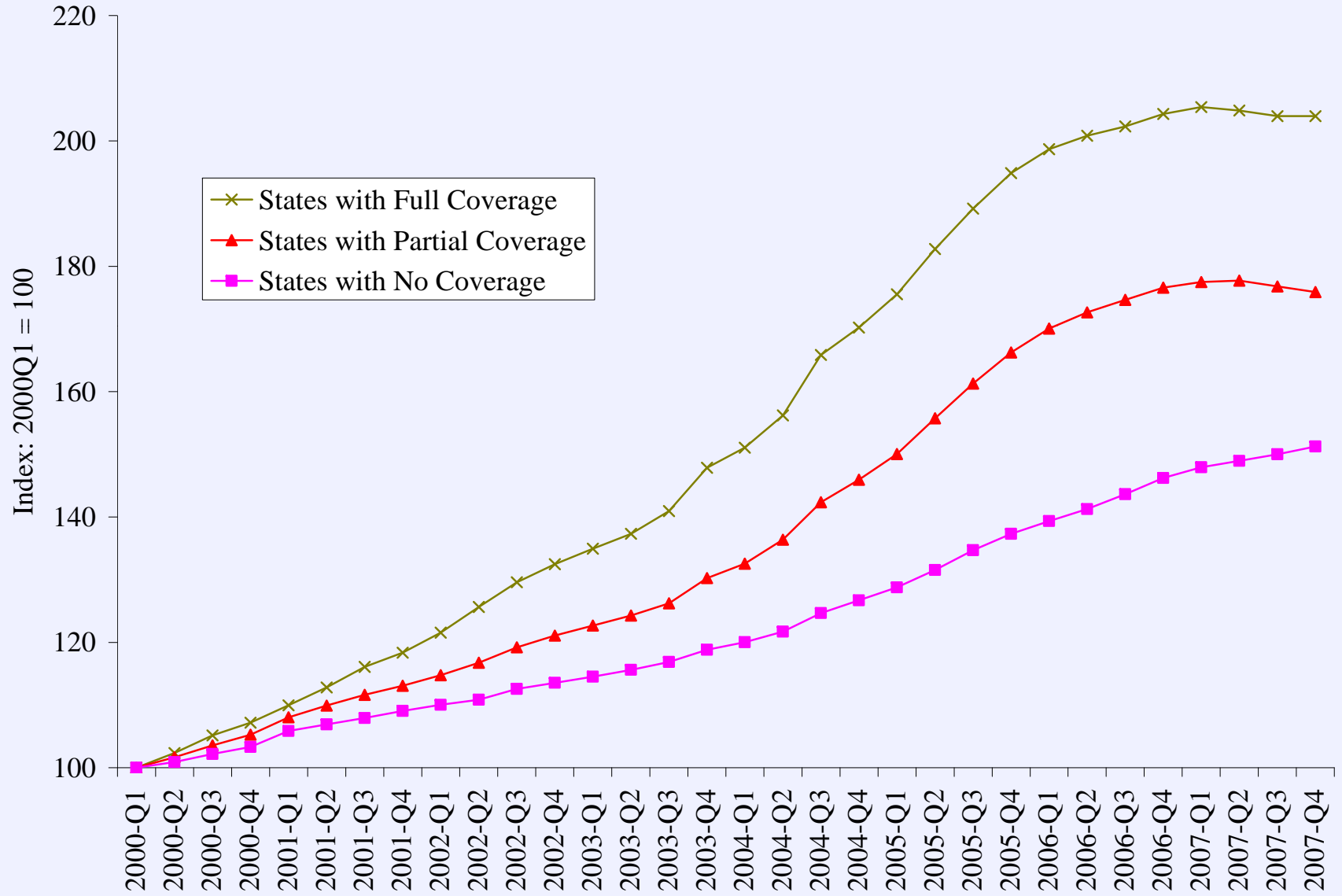


Figure 5: State-Level Annual Home Price Appreciation (OFHEO) vs. State-Level Changes in Foreclosure Inventory Rates  
(Foreclosures growth regression, R sq = 0.70, coef on growth of price = -0.12)

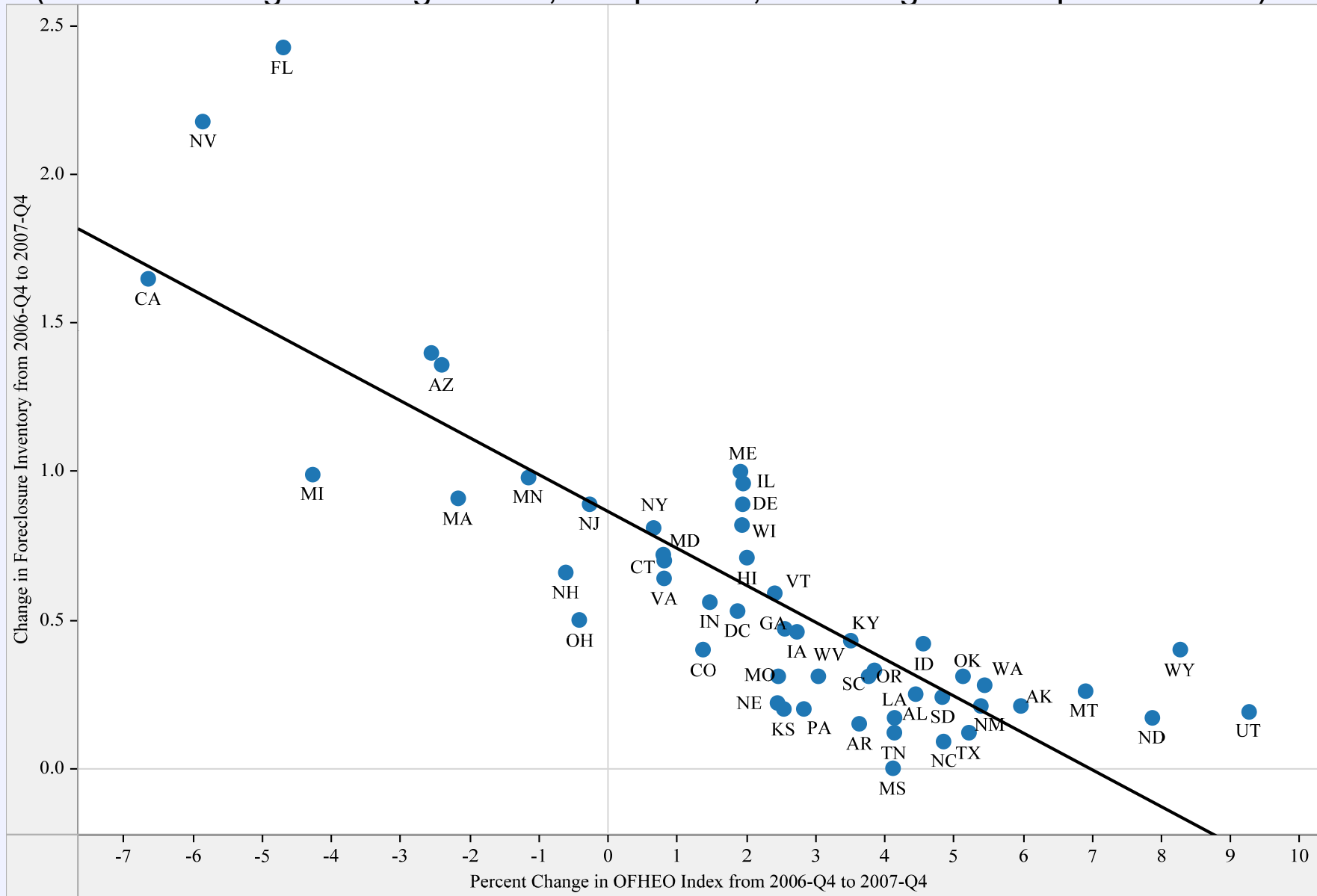


Figure 16: Real Household Net Worth Per Capita

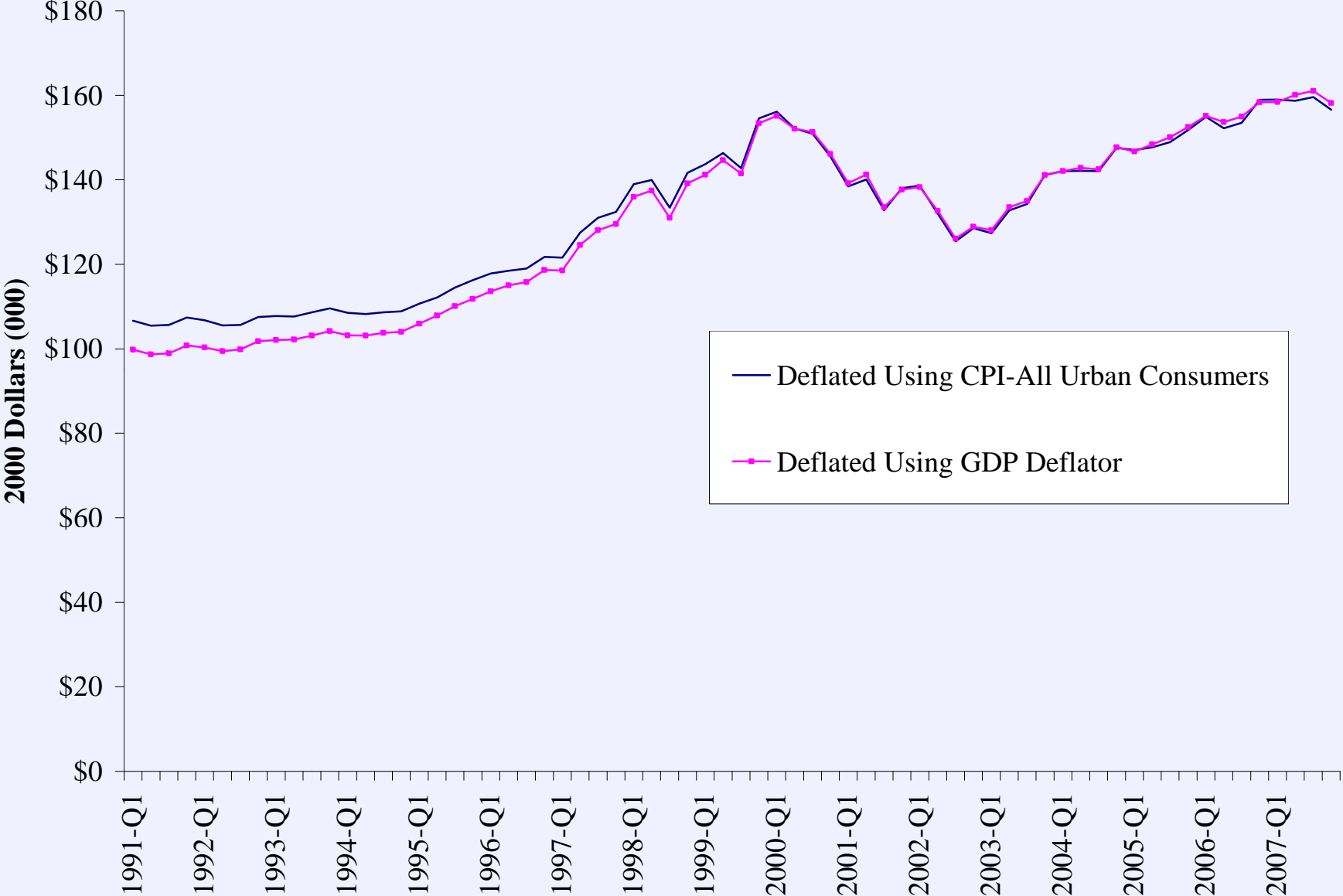
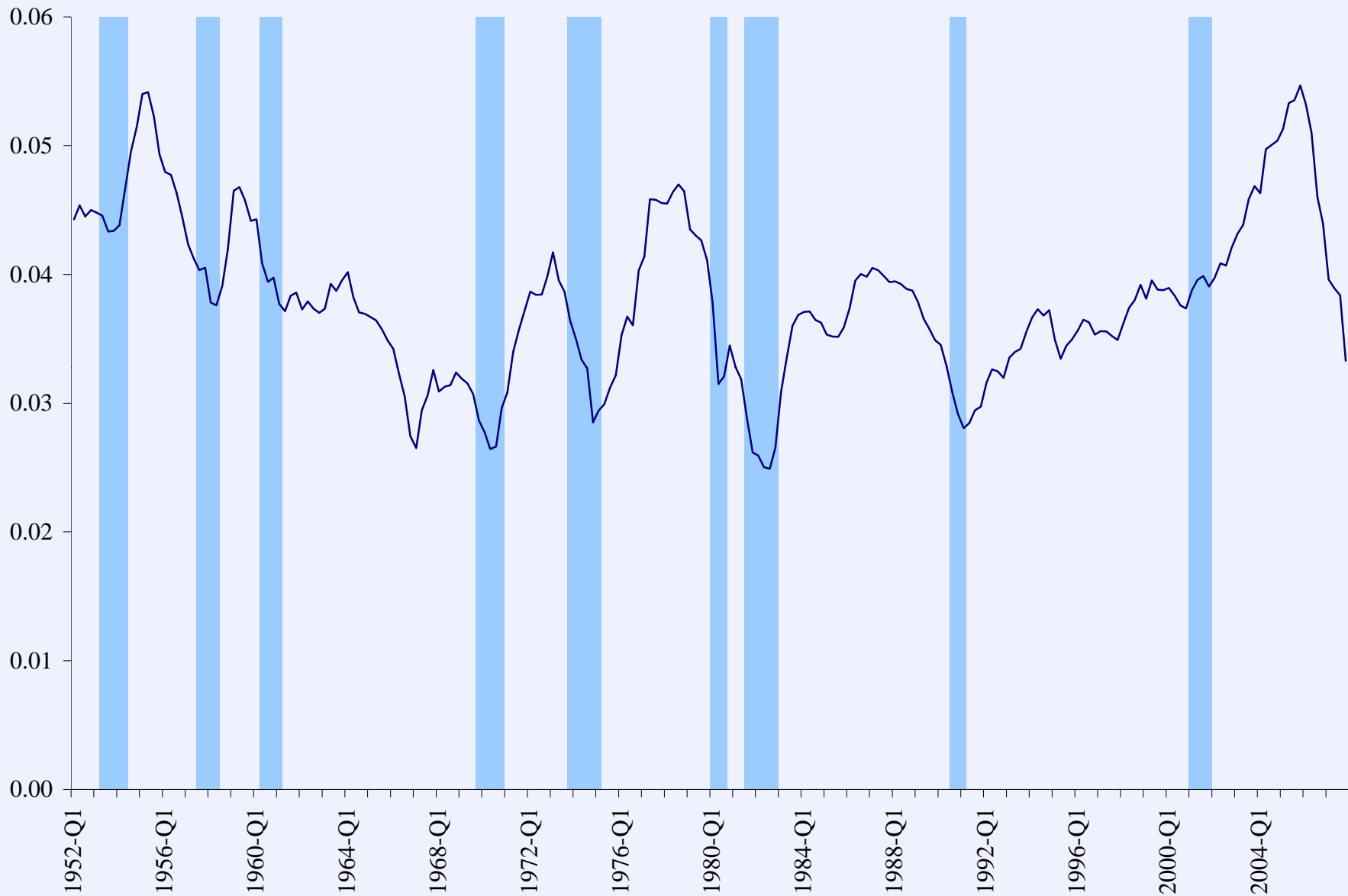


Figure 8: Residential Investment by Household Sector Relative to GDP



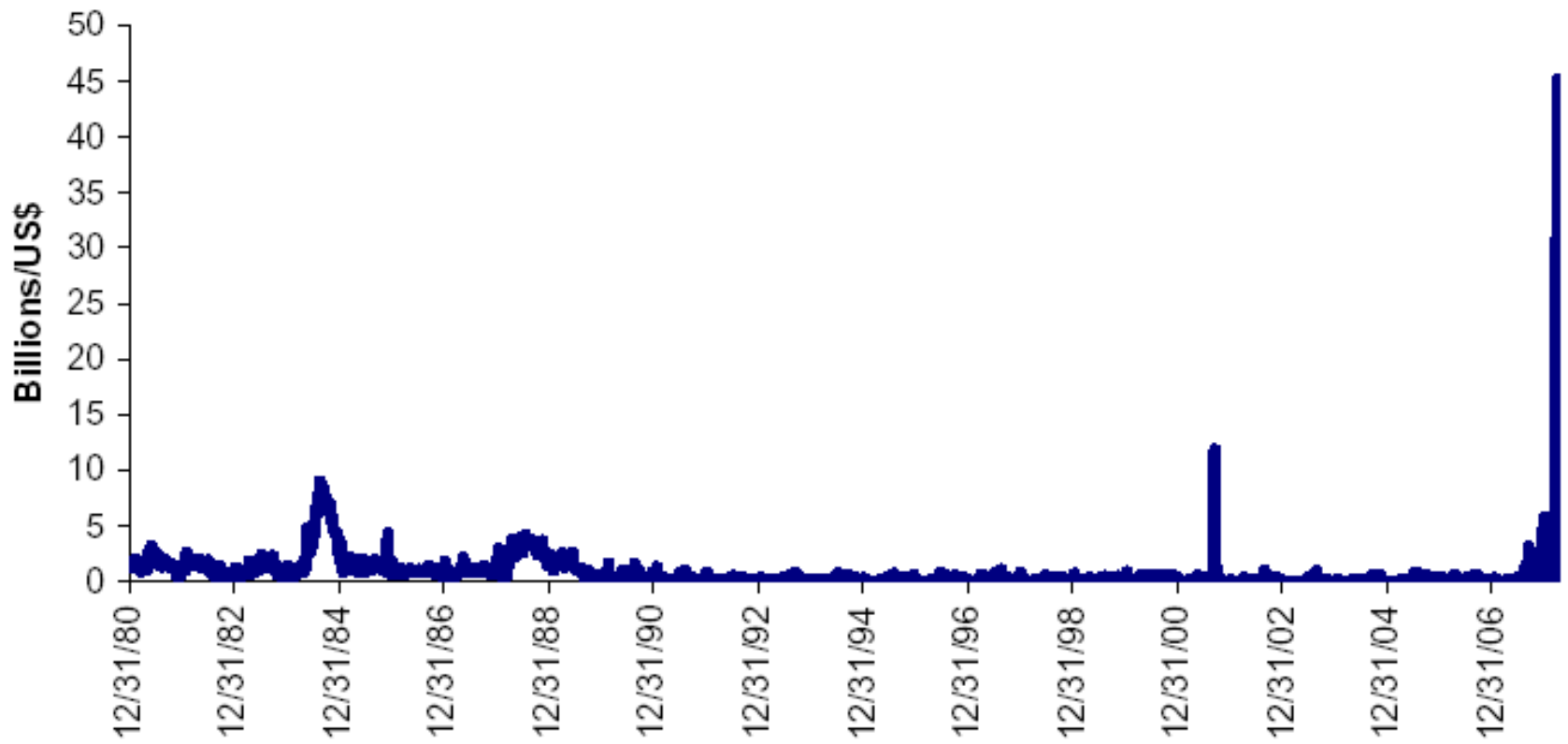
# Severe Recession Risk Minimal

- Credit crunch will not be severe.
- Credit spreads are elevated, but were too low before the turmoil.
- Housing prices will not decline very much, and declines will be concentrated in some regions.
- Housing wealth effects probably have been overestimated by the Fed (2%, not 5% elasticity – see Gan)
- Jobs, wages, IP, global growth continue to be positive (or at least not highly negative) factors looking forward.

# Policy Responses

- **Fed policy response** has been aggressive, perhaps appropriately; and is much more aggressive than 1970, 1987, and 1998 responses. Inflation is accelerating and is a risk going forward.
- **Discount window:** Section 23 forbearance, increased access to avoid interbank lending channel, and access for IBs all were appropriate, and consistent with Bagehot's rule and historical evidence on central bank lending effectiveness.
- **M-LEC** was a bad idea (phony books, postponement of losses contribute to prolonged shocks and high adverse selection costs).
- **Foreclosure relief:** Loss sharing with appropriate incentives, alongside putting an end to subsidizing imprudent leveraging; assist homeowners with downpayment matching grants.
- **Bank regulatory response:** Reform Basel II to (a) get rid of reliance on ratings (at least letter grades), (b) incorporate real market discipline rather than ratings and models, (c) require additional simple leverage limit, as in US (North Rock failure would have probably been avoided), (d) require prompt corrective action, (e) FDICIA reforms of lending and resolution of failed institutions, and (f) substantially raise minimum capital ratio on a phased in basis (for IBs too?; where to draw line?), but make the much higher minimal ratio adjust countercyclically.
- **Reform GSEs:** Fannie / Freddie risks are unacceptably high, lack a resolution mechanism. FHLBs risk also high (\$51 billion of Countrywide's \$100 billion in assets), possible asset stripping of FDIC.

### Weekly Discount Window Lending



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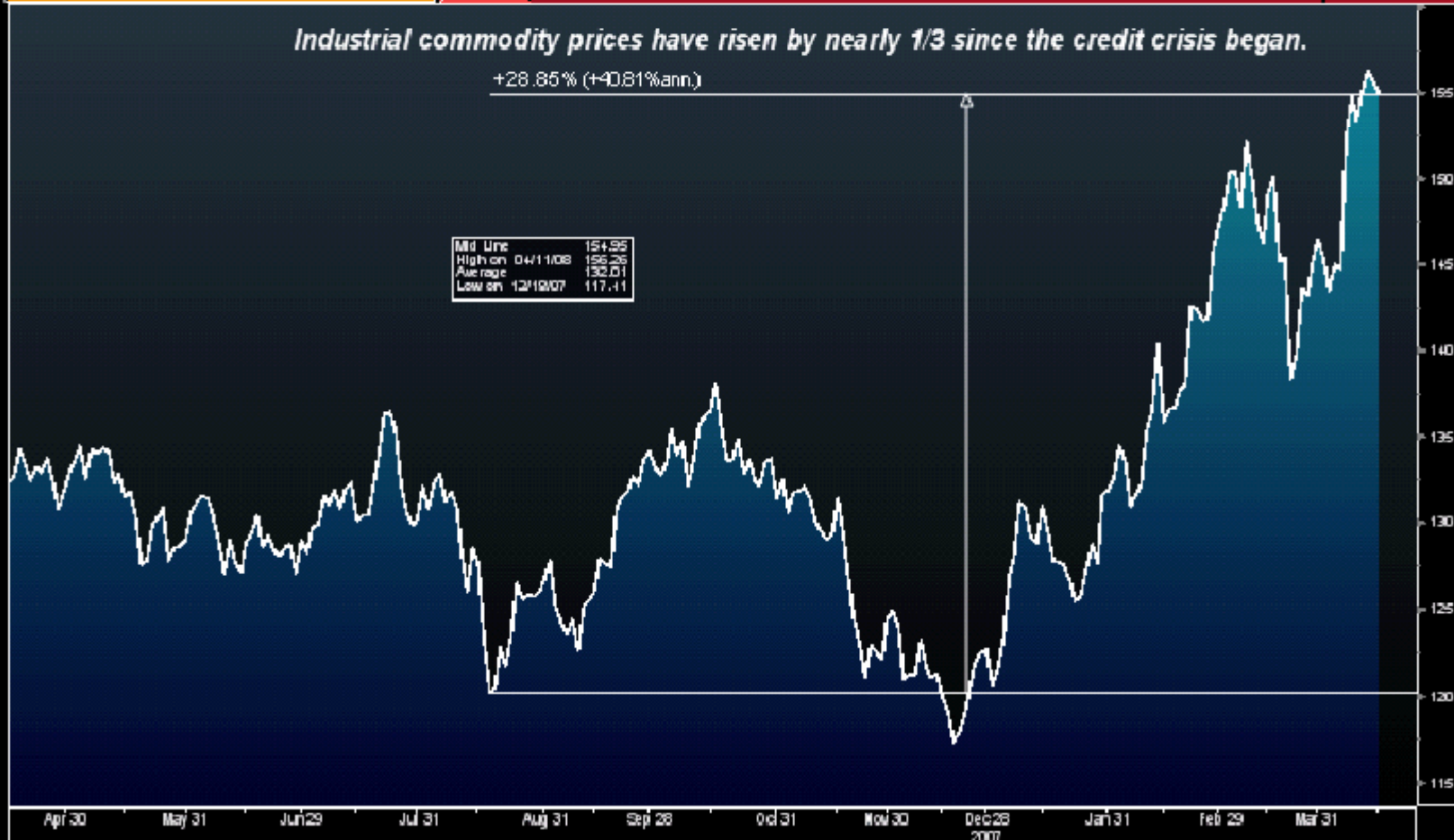
GP - Line Chart

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*Industrial commodity prices have risen by nearly 1/3 since the credit crisis began.*

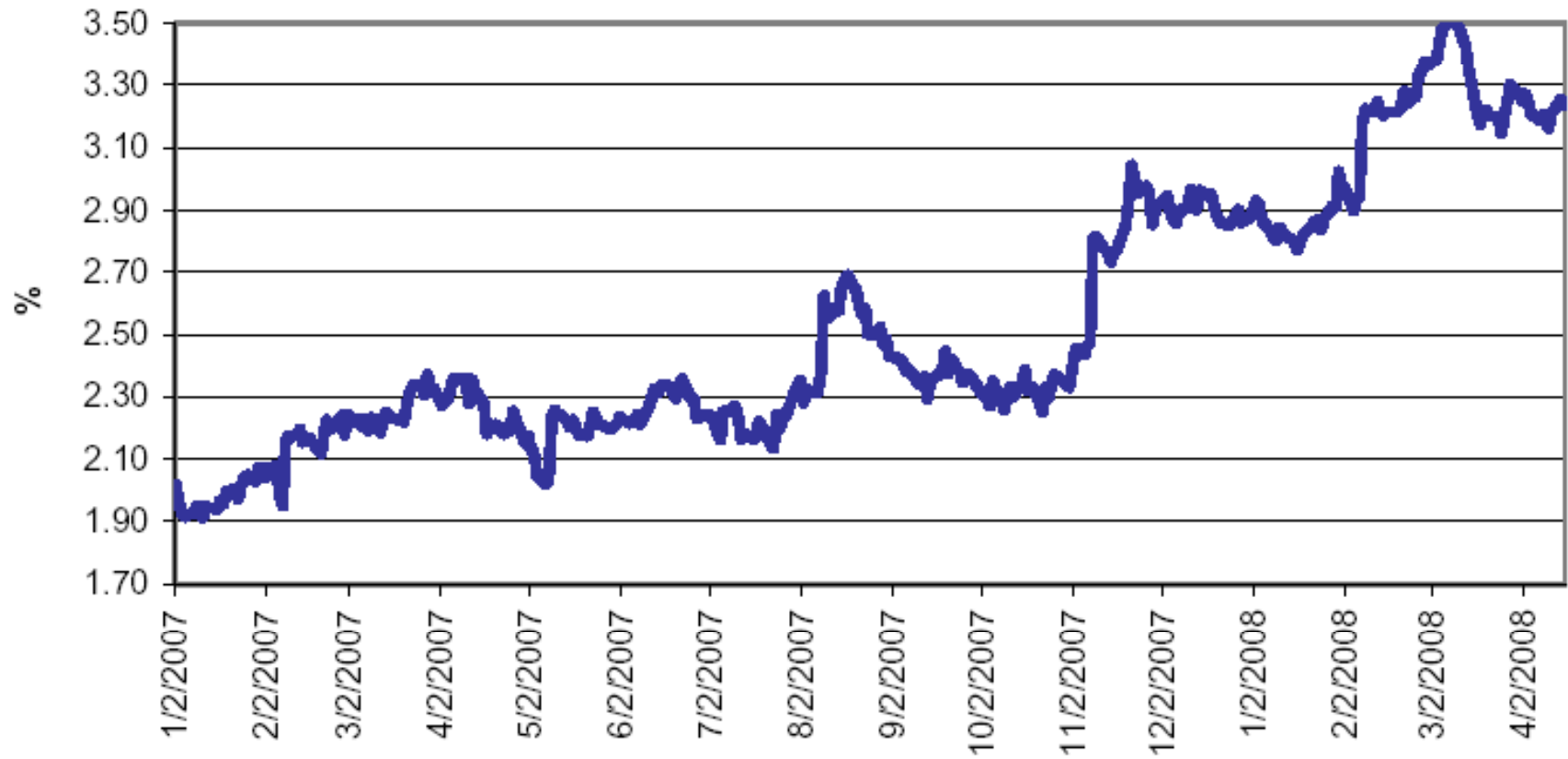
+28.85% (+40.81%ann.)

Mid Line	154.95
High on	04/11/08 156.26
Ave range	132.01
Low on	12/19/07 117.11



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 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
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### Cleveland Fed 10-Year TIPS Spread



## Inflation in Dollar-Linked Countries

*(Panama, Sudia Arabia, Hong Kong, China)*

