

Econ 520
Money and Banking
Prof. J. H. McCulloch

Lecture 1

The 2008 Crisis in the American Economy

M&B Chapter 1

Origin of Crisis

For years prior to 2007 –

Many mortgages “subprime”

little if any equity

excessive payments relative to income

often no documentation of value or income

NINJA mortgages:

No Income, No Job, No Assets

Encouraged by Fannie Mae and Freddie Mac

Govt sponsored mortgage intermediaries

Led to self-sustaining bubble in house prices

2007-2008

Borrowers realized they were overextended,

cut back on spending, borrowing

Housing bubble stalled, then started to pop

Delinquencies and foreclosures spread

Washington Mutual Savings & Loan failed

Countrywide Financial failed

Fannie and Freddie rescued by Fed in 2008

Investment banks Bear Stearns, Lehman Bros failed

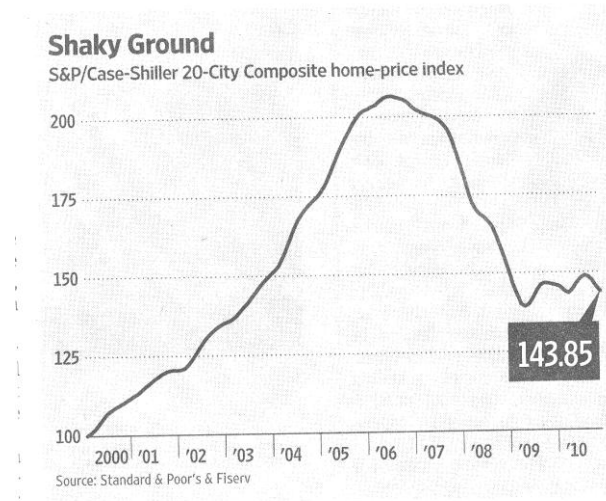
Bank Holding Companies in trouble

GDP fell, Unemployment rose.

How serious compared to past recessions?

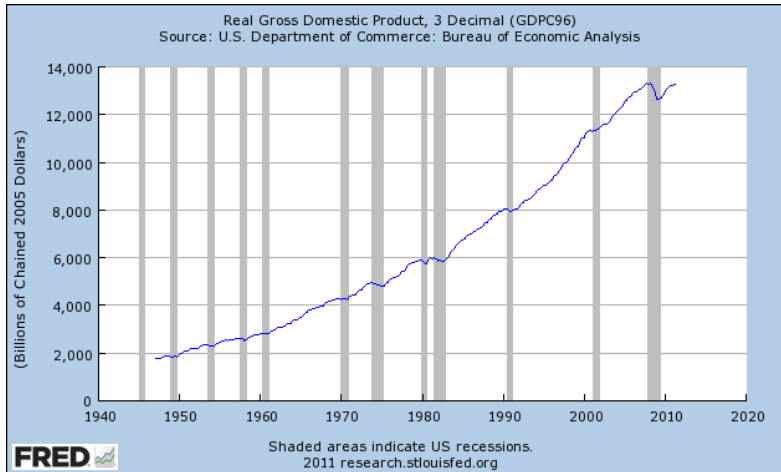
Pundits often say “worst since Great Depression of 1930s.”

Is this true? Or just alarmism?



Real GDP

Decline in real GDP in selected downturns

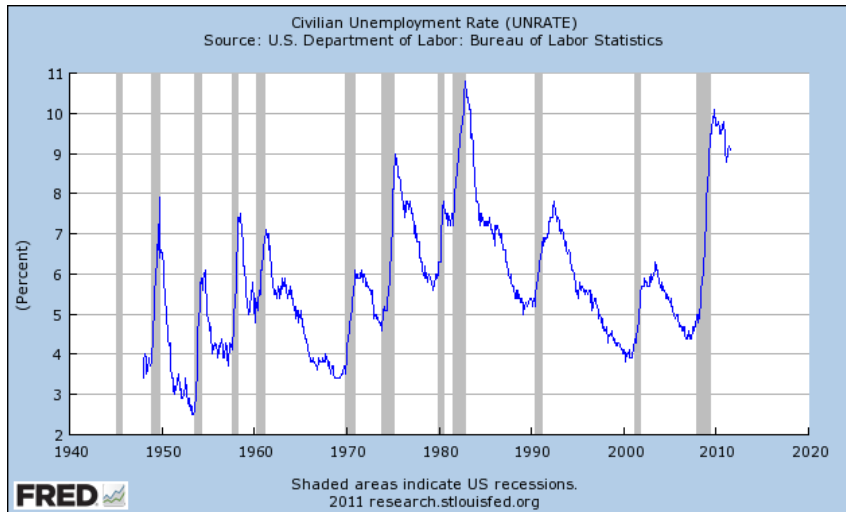


1929-1933	-26.7%
1937-1938	-3.3%
1944-1947	-9.4%
1957Q3-1958Q1	-3.7% *
1973Q2-1975Q1	-3.2% **
1980Q1-1980Q3	-2.2%
1981Q3-1982Q3	-2.9%
2007Q4-2009Q2	-4.1%

3/11 revision shown. * -3.1%, 9/10 version. ** -3.8%, 9/10 version

Current recession slightly worse than 1957-58
but 1944-47 twice as bad,
1929-33 six times worse.

Unemployment



Selected peaks in US Unemployment Rate

1932	22.9%
1938	12.5%
1949	5.9%
7/1958	7.5%
5/1975	9.0%
7/1980	7.8%
11-12/1982	10.8%
6/1992	7.8%
6/2003	6.3%
10/2009	10.1%

Current recession severe:

10.1% max 10/09, still 8.3% (2/12)
but 1982 worse @ 10.8%,
1932 twice as bad @ 22.9%.

Unemployment aggravated by

2007 increases in Federal, state minimum wages

40.7% Federal increase 2007-09

2008 extension of Unemployment Benefits

from permanent 26 weeks (since 1970)

to 99 weeks “extended benefits” through 5/12,

@ 73 weeks through 12/12.

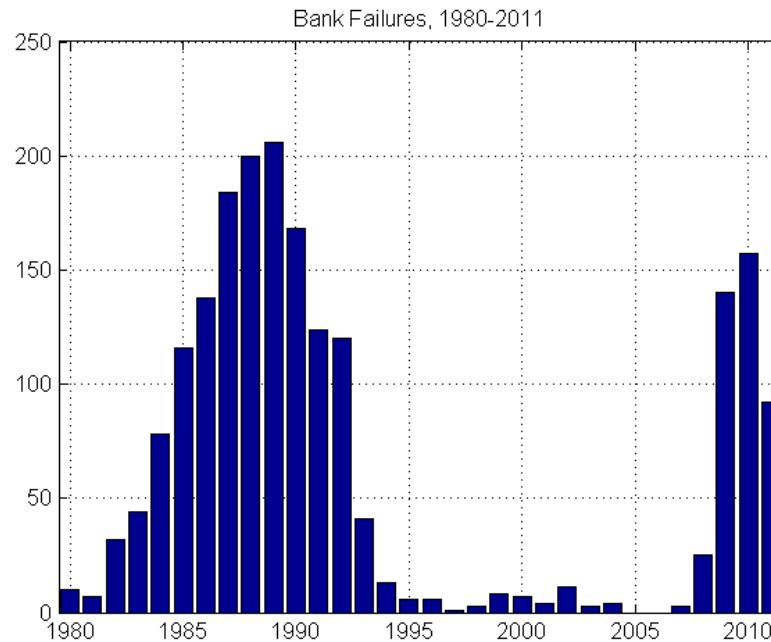
Both increase unemployment for lowest skilled workers.

16-19 year olds 27.1% (peak 10/10)

< HS diploma over 25 yrs 15.7% (peak 11/10)

Larry Summers (1992 book) warned that monetary policy should not be used to offset U caused by U benefits.

Bank Failures



Current rate of failures serious:

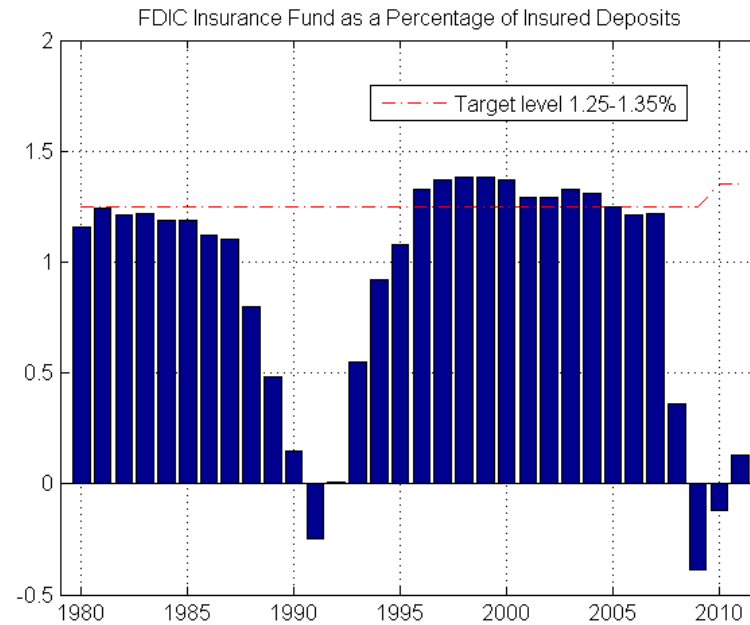
140 in 2009, 157 in 2010, 92 in 2011

but 1987-90 worse, over 100 failed per year 1985-92.

So far, 85-92 banking crisis much worse than current by this measure
1930-33, *thousands* of banks failed each year.

Current crisis doesn't compare.

FDIC insurance fund



2008 below statutory target level of 1.25% of insured deposits

2009 in hole at -.39%, but recovered to +.13% by 2011

1998-90 similar, reached -.25%

back on target by 1995, due to

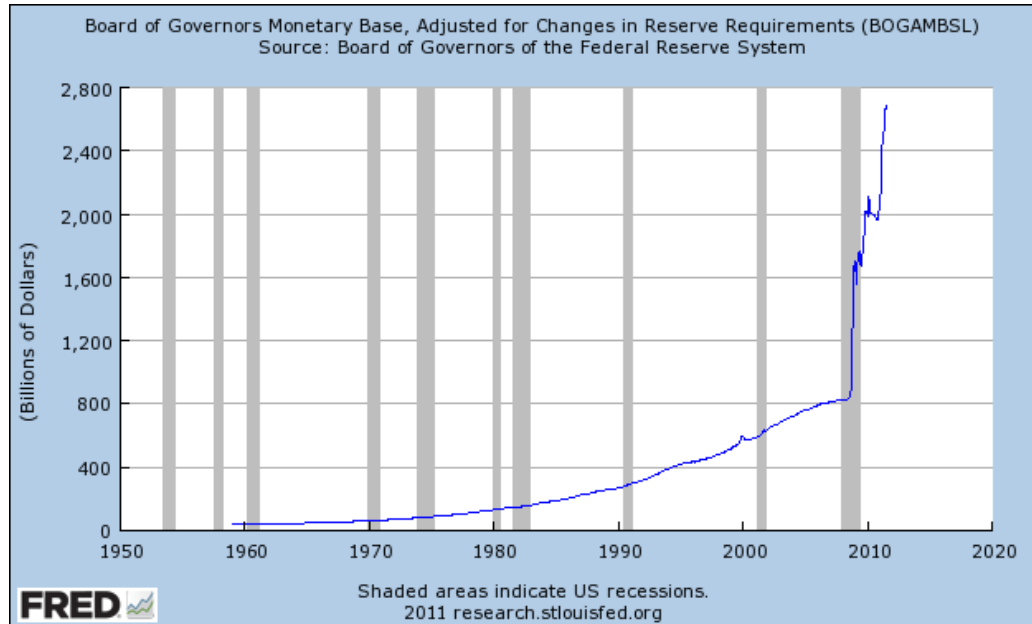
improved economy,

higher premiums,

tighter capital standards from 1991 legislation

Monetary Base Explosion

Base more than doubled by end of 2008, now has tripled



Beginning in 2008, Fed advanced \$1.8 trillion to bail out

Fannie Mae, Freddie Mac

AIG

Bear Stearns

Mortgage Backed securities

etc.

Ordinarily, this would double Money supply, Price Level
through *Quantity Theory of Money*

High money growth
usually accompanied by
comparably high inflation:

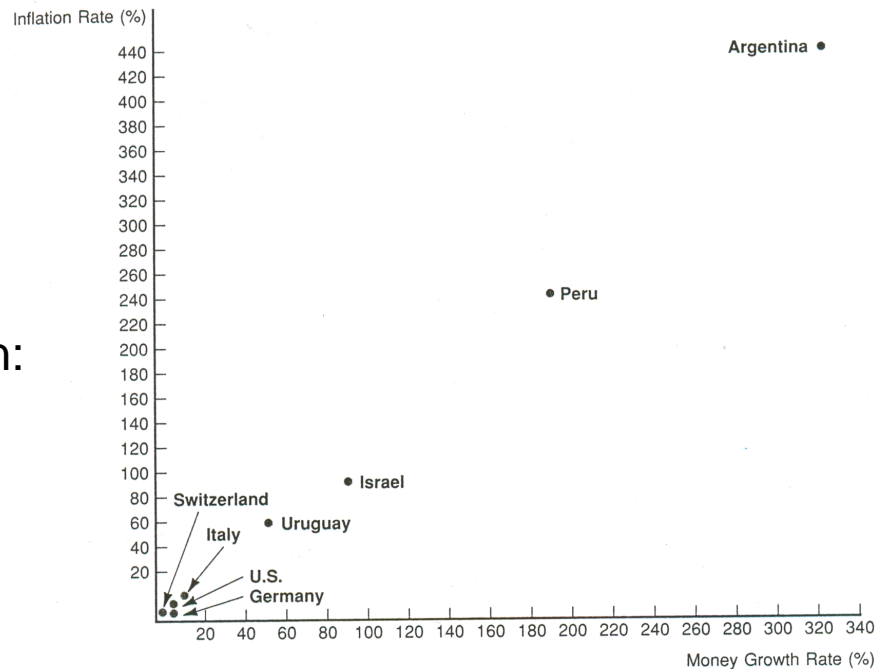
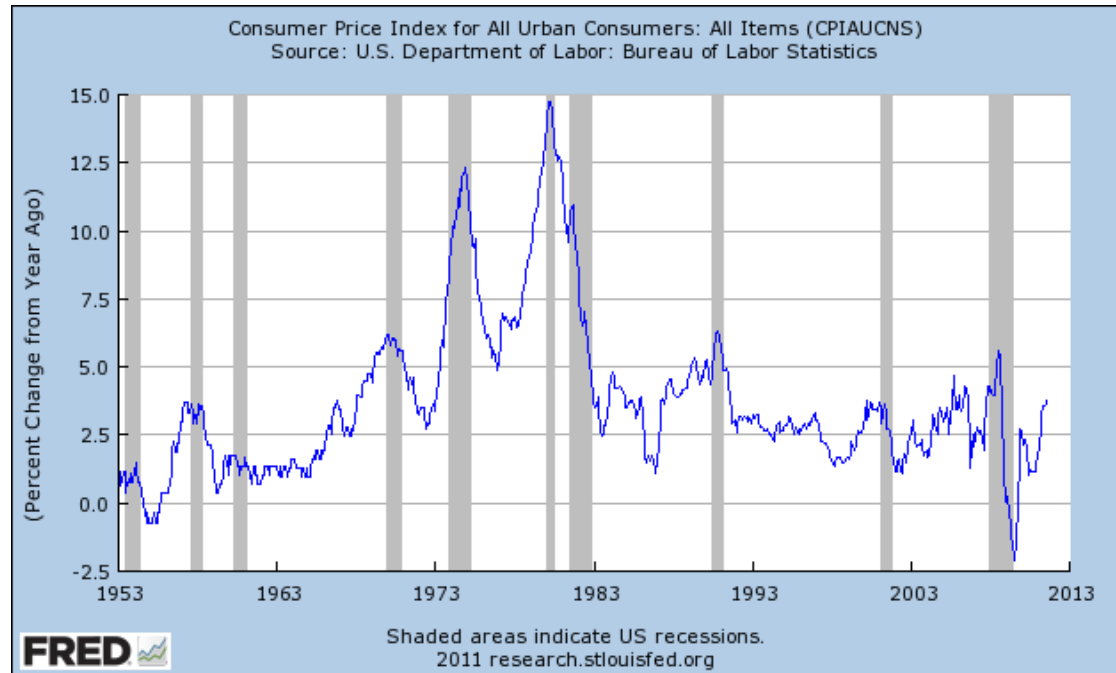


Figure 1.2
Average Inflation Rate Versus Average Rate of Money Growth for a Number of
Countries: 1980–1990 Source: *International Financial Statistics*.

from Mishkin, Money and Banking

US not immune from inflation



Double digits 1973-75, 1978-81.

But since 2008 –

Fed paying banks interest on over \$1.6 T idle excess reserves

Pumps profits into banks with no risk to them

Current Inflation

Only 2.9% per year (2/11 to 2/12)

Can Fed unwind base explosion without inflation?

Is deflation a valid concern?

Selected US Deflations

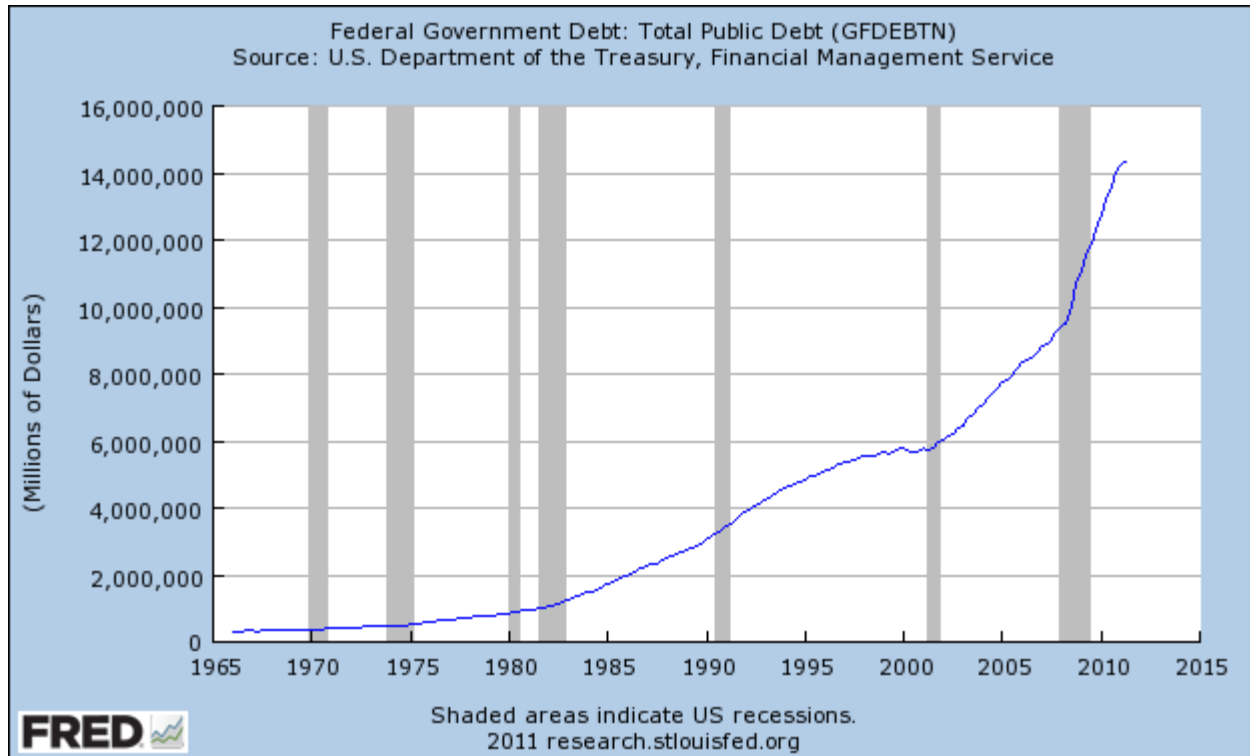
Period	Deflation
6/1920-8/1922	20.6%
11/1929-3/1933	26.2%
10/1937-4/1939	5.5%
8/1948-1/1950	3.8%
7/2008-12/2008	3.5%

1929-33 deflation of 26.2% led to massive bankruptcies, foreclosures
Caused by post-WWI complications of Gold Standard.

2008 deflation of 3.5% caused by transitory gas price decline
from over \$4/gallon in summer to under \$2 by November.
Smaller than 1948-50, quickly reversed.

No reason for 1929-33 deflation to recur under fiat money standard.

National Debt



Has increased \$5 Trillion since 2008

⇒ average taxpayer \$55,000 deeper in debt than 2008,
owes \$127,000 total.

(90 million taxpaying returns)

Outline of course

- Part I
 - Why use Money?
 - US Monetary Standard
 - Price level
 - Money & Prices: Quantity Theory of Money
 - Interest Rates
 - Loanable Funds Model of Real Rate
 - Nominal vs Real Rates
- Part II
 - Quantity Equation and Velocity
 - Inflationary Finance
 - Inflation and Unemployment: Phillips Curve

- Part III
 - The Monetary Aggregates
 - Commercial Banks & deposit creation
 - Federal Reserve System
 - Monetary Base Equation
 - Money and Credit: the Taylor Rule
 - War & Peace: US inflationary episodes
- Part IV
 - Financial Intermediation
 - mortgages, thrifts, Fan & Fred
 - Bank and Thrift regulation
 - More on 2008 crisis

- Part V
 - Foreign Exchange Rates
 - International Monetary System
- Recurring theme
 - What made the Great Depression so Great?
 - Are we in for another one?
 - How does it relate to current crisis?

Thursday:

- Why Use Money?
 - M&I Ch. 1
- The US Monetary Standard
 - M&B Ch. 3

HW1

- Weekly HW due Friday 5:00 PM
in Kevin (Feng) Guo's box outside
Arps 410