* Some Controversial Aspects of the Financial Meltdown of 2008

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Four aspects of the Financial Crisis

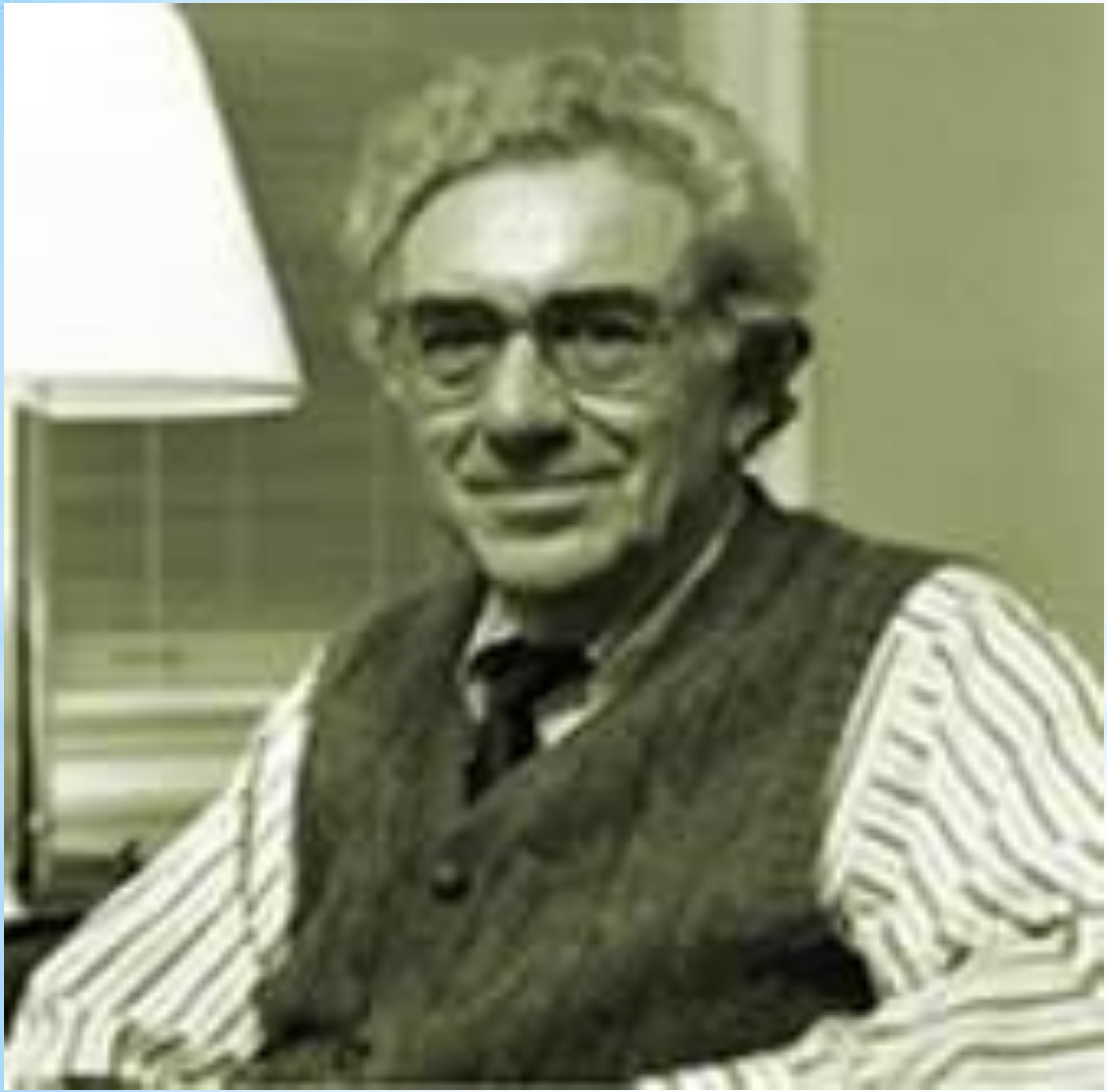
a) Cassandras

b) Wasted crisis

c) Counterfactuals

d) The consequences of the Meltdown

The Warning



Hyman Minsky 1919-1996

Financial system in inherently unstable

His thesis: stability is destabilizing

2008: was a ‘Minsky moment”

The stabilizing institutions of the FDR era had been circumvented by the shadow banking system.

Regulation had not kept up with the “innovations”.

Instead regulations were slowly dismantled, on the erroneous and dogmatic belief that ‘free’ markets are self-regulating.

Unfortunately, Minsky’s warnings were ignored by everyone.

An important attempt to regulate derivatives in 1998:

Brooksley Born, CFTC

Frontline: available on PBS

In wake of the Asian crisis of 1997

Greenspan & Co. seemed invincible

Summers: "we start with the idea that you can't repeal the laws of economics. Even if they are inconvenient.“

Forgot Greenwald-Stiglitz theorem (1986)

"Rubin, Greenspan and Summers have outgrown **ideology**. **Their faith is in the markets and in their own ability to analyze them.**

Greenspan found in objectivism a sense that **markets** are an expression of **the deepest truths** about human nature and that, as a result, they will ultimately be correct."

“Their success has turned them into a kind of free-market Politburo on economic matters.”

Their Ideology: “Regulation is **superfluous**.”

* In fact Greenspan and Bernanke were dead wrong:

* Markets are not efficient or self-correnting in the presence of imperfect information or systemic risk

* See the work of Akerlof and Stiglitz


LIVE
WHITE HOUSE
First on CNBC
July 2005

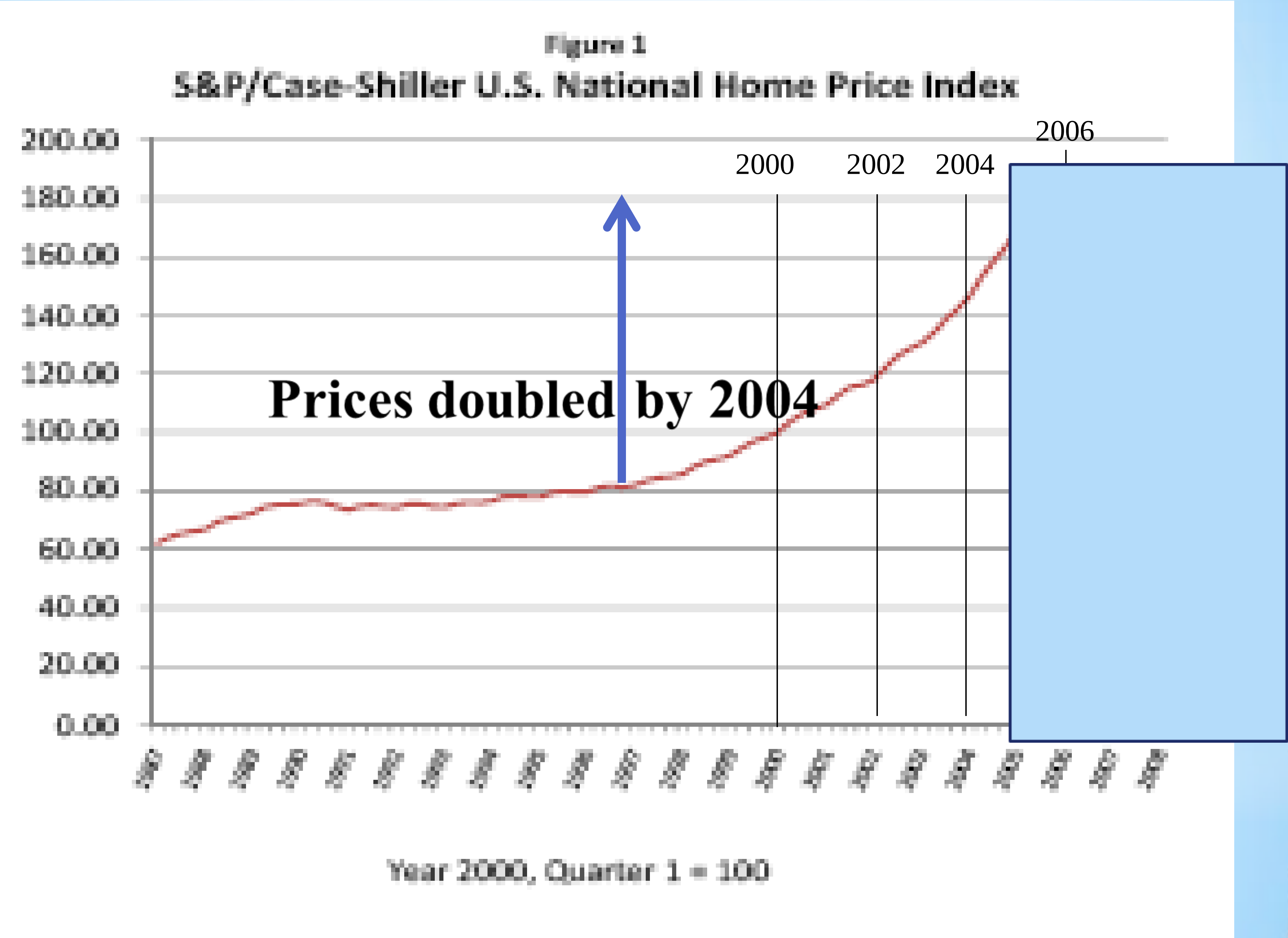
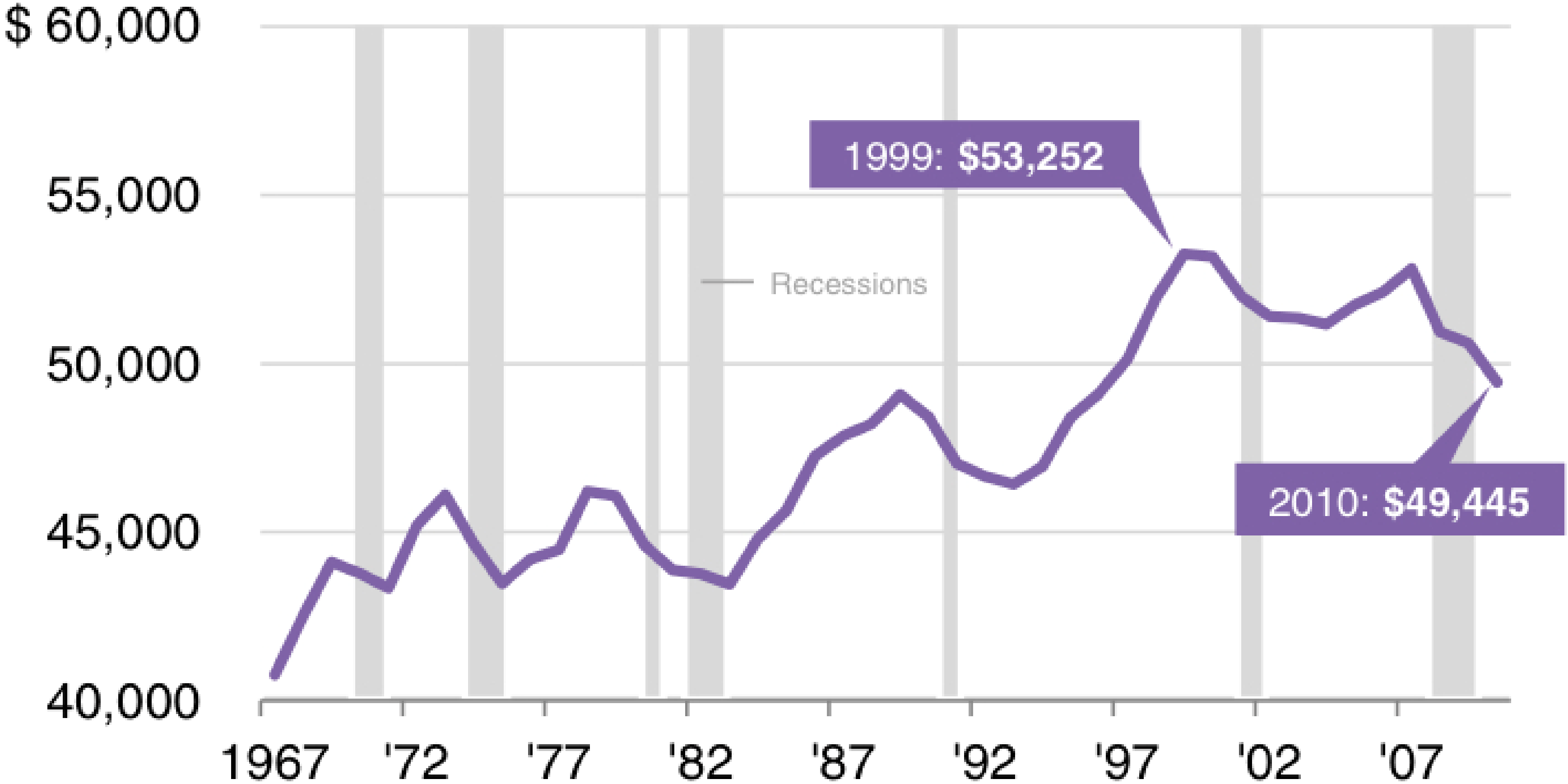


Figure 1
S&P/Case-Shiller U.S. National Home Price Index
200.00
180.00
160.00
140.00
120.00
100.00
80.00
60.00
40.00
20.00
0.00
2000
2002
2004
2006
Prices doubled by 2004
Year 2000, Quarter 1 = 100

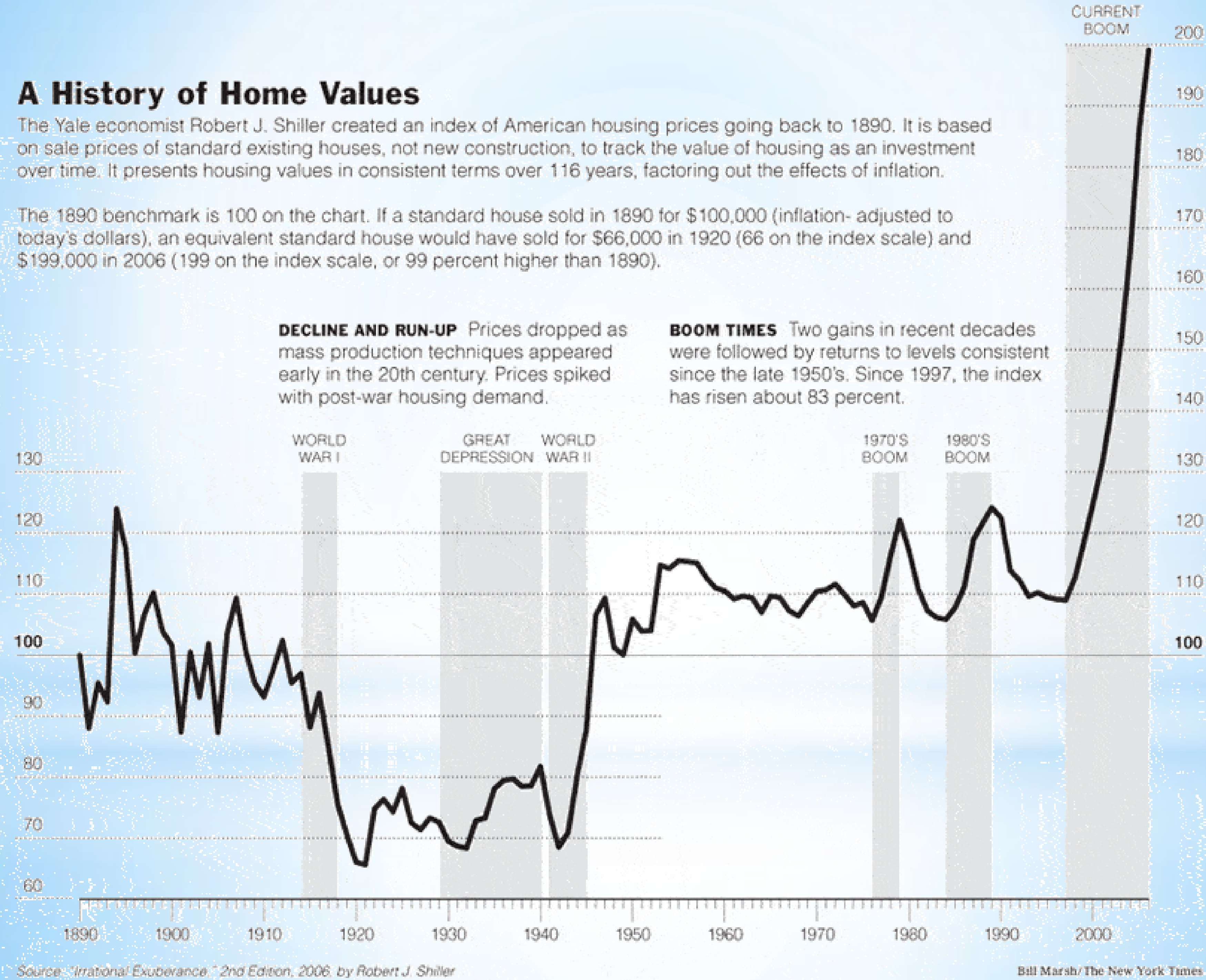
Median household income has declined over the past decade.

Median household income, inflation-adjusted, 1967 to 2010



Housing has not yet recovered.

S&P/Case-Shiller U.S. national home price index, 2000 Q1 = 100


A History of Home Values
The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.
The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for $100,000 (inflation- adjusted to today's dollars), an equivalent standard house would have sold for $66,000 in 1920 (66 on the index scale) and $199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).
DECLINE AND RUN-UP Prices dropped as mass production techniques appeared early in the 20th century. Prices spiked with post-war housing demand.
BOOM TIMES Two gains in recent decades were followed by returns to levels consistent since the late 1950's. Since 1997, the index has risen about 83 percent.
WORLD WAR I
GREAT DEPRESSION
WORLD WAR II
1970'S BOOM
1980'S BOOM
CURRENT BOOM
200
190
180
170
160
150
140
130
120
110
100
90
80
70
60
1890
1900
1910
1920
1930
1940
1950
1960
1970
1980
1990
2000
Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller
Bill Marsh/The New York Times

* Bernanke did not see the Meltdown coming but many people with an open mind did ….

The Run-up in Home Prices: A Bubble

Dean Baker

Challenge, Vol. 45, No. 6 (NOVEMBER–DECEMBER 2002), pp. 93–119

2002

Warren Buffett to his stockholders, Berkshire Hathaway‘s **2002 ANNUAL REPORT:**

History teaches us that a crisis often causes problems to correlate in a manner un-dreamed of in more tranquil times…

In our view, derivatives are **financial weapons of mass destruction**, carrying dangers that, while now latent, are potentially lethal.

John Cassidy, “Blowing Bubbles” *New Yorker* July, 2004:

“Given Greenspan’s role in promoting and prolonging the stock-market bubble that burst in 2000, the deference that surrounds him seems a little overdone…
even some of Greenspan’s colleagues are concerned that one bubble has given way to another…
[Yet,] Greenspan refuses to contemplate such a catastrophe. On Capitol Hill recently, he insisted that the economy ‘seems to be on track.’”

*Peter Schiff saw it coming

Robert Shiller warned in June 2005 that, “The [housing] market is in the throes of a bubble of unprecedented proportions that probably will end ugly.”

Robert Shiller, “The Bubble’s New Home,” *Barron’s,* June 20, 2005.

In August 2005 Paul Krugman argued that there was definitely a housing bubble on the coasts and that, indeed, the air had already begun leaking out.

Paul R. Krugman, “That Hissing Sound,” *The New York Times*, August 8, 2005.

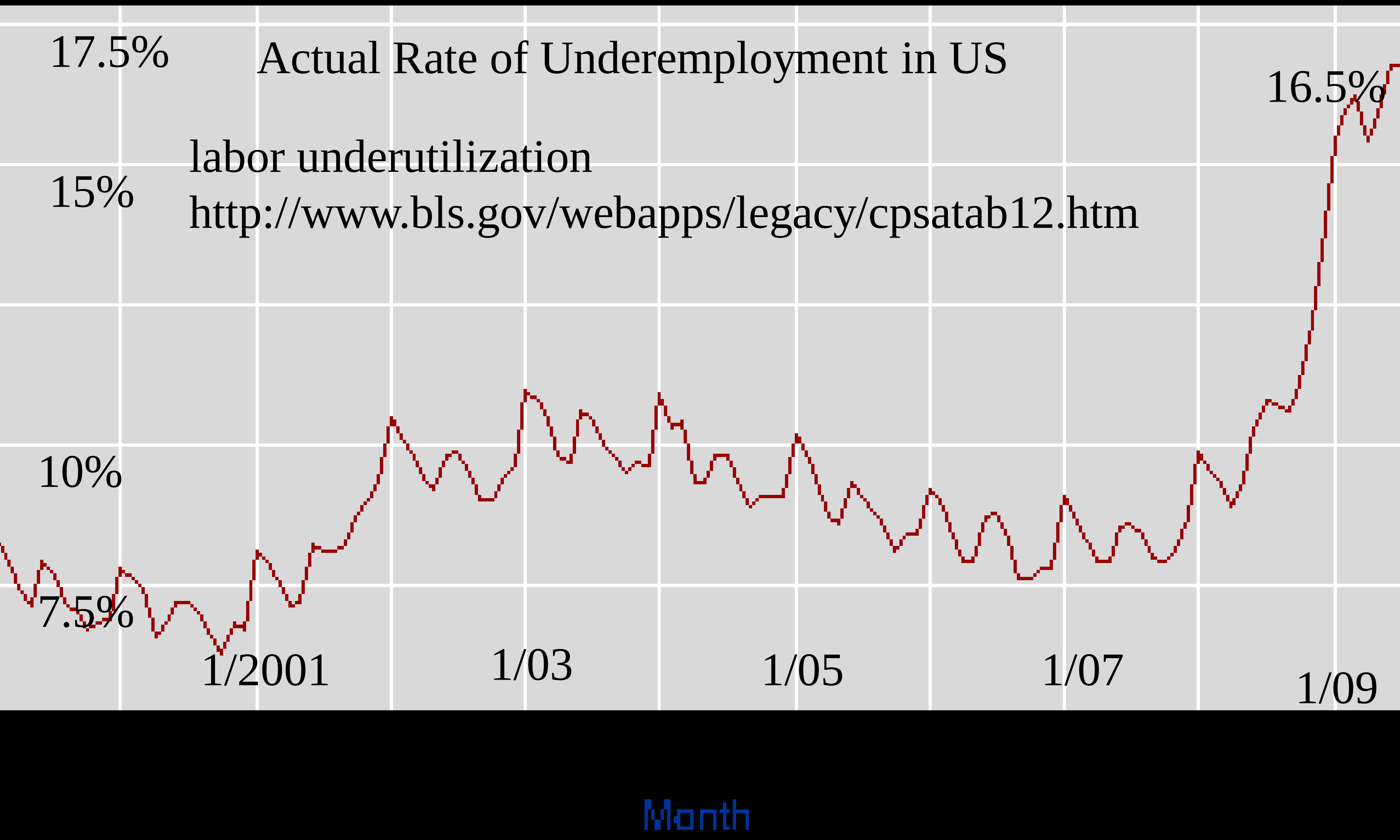
WSJ article 2007 on Edward Gramlich:

Edward Gramlich, Fed governor from 1997 to 2005, said he proposed to Mr. Greenspan around 2000, when predatory lending was a growing concern, that the Fed use its discretionary authority to send examiners into the offices of consumer-finance lenders.

Knowing it would be controversial with Mr. Greenspan, Mr. Gramlich broached it to him personally rather than take it to the full board.

"He was opposed to it, so I didn't really pursue it," says Mr. Gramlich, a Democrat who was one of seven Fed governors.

Part III. Consequences


Actual Rate of Underemployment in US
17.5%
16.5%
labor underutilization
http://www.bls.gov/webapps/legacy/cpsatab12.htm
15%
10%
7.5%
1/2001
1/03
1/05
1/07
1/09
Month

Capacity utilization US, Mfg, Mining, Electric and Gas utilities

78%

Wasted Crisis
Response to the crisis miserable

1. Slow realization of the danger. Models were predicting that all was well. Bernanke resisted policy change. He kept on saying that things were ok.

2. Their models said diversification is good. Instead the innovations were spreading risk all over the globe. Subprime mortgages of $3 trillion was not a big deal.

3. They continued to use wrong models.

4. During the crisis the main focus on Wall Street which did recover.

5. Very little attention paid to “Main Street.”

6. The same economists were put in charge who wrecked the ship in the first place.

7. We are now half way through a “lost decade” which will become more like a lost generation and a turning point.

8.”Market discipline thing of the past.” Moral hazard rampant.

9. Banks are more powerful than ever before.

10. Inequality made worse by the way the bailout was handled.

The Counterfactual:
The Komlos plan

1) **Nationalize the insolvent Banks.**
   We would not have had to pay bonuses.

2) **Break up TBTF Banks.**

3) **Regulate banks**
   Glass-Steagall
   Eliminates “Doom Loop”.
   No more Moral Hazard.

4) **Help mortgage owners instead.**

Bailout Main Street.

TARP money to home owners.

No more toxic assets,

Increase aggregate demand.

Recession milder and over by 2010

Hence, no Republican majority in Congress.

No Tea Party.

This is trickle up economics and is similar to FDR's New Deal: Attack the source of the problem directly.

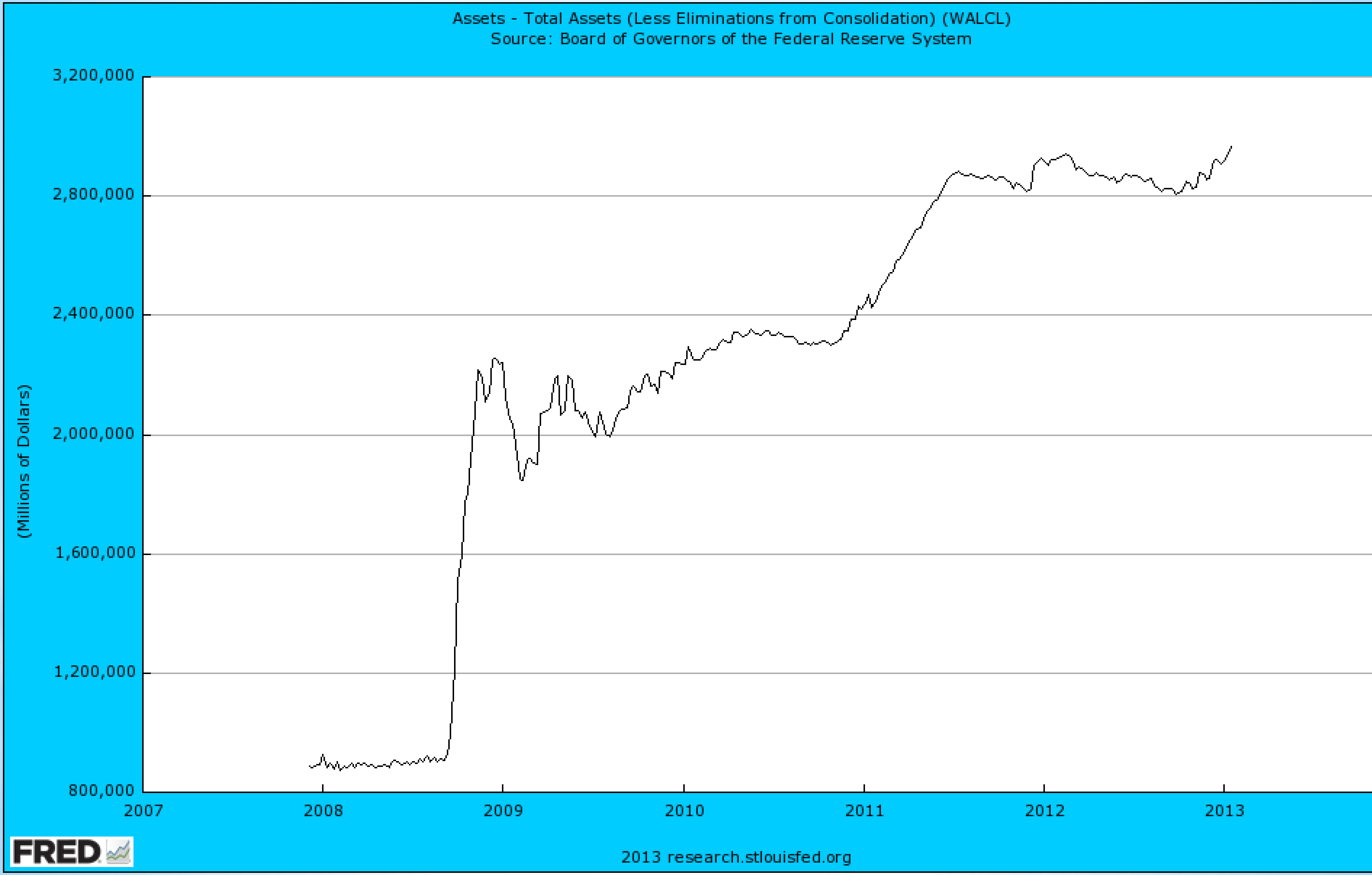
Do not aid the banks in the hope that they, in turn, will help homeowners.

That is too indirect and risky.

No guarantee that they will do it

* The aftermath of the Financial crisis: The Great Slump

With QE3 Assets are now at $3.3 Trillion



A Dozen Challenges to the U.S. Economy:

1) Government Budget Deficit

2) Large Private Debt

3) Foreign Trade Imbalance

4) Endemic long-term Un(der)employment

5) Obscene Inequality

6) Political stalemate

7) Military challenges around the globe

8) Stagnating or declining wages or no wages at all

9) New historical epoch is difficult to recognize and comprehend the turning point or tipping point (example: Gorbachev)

10) Slow growth / no growth

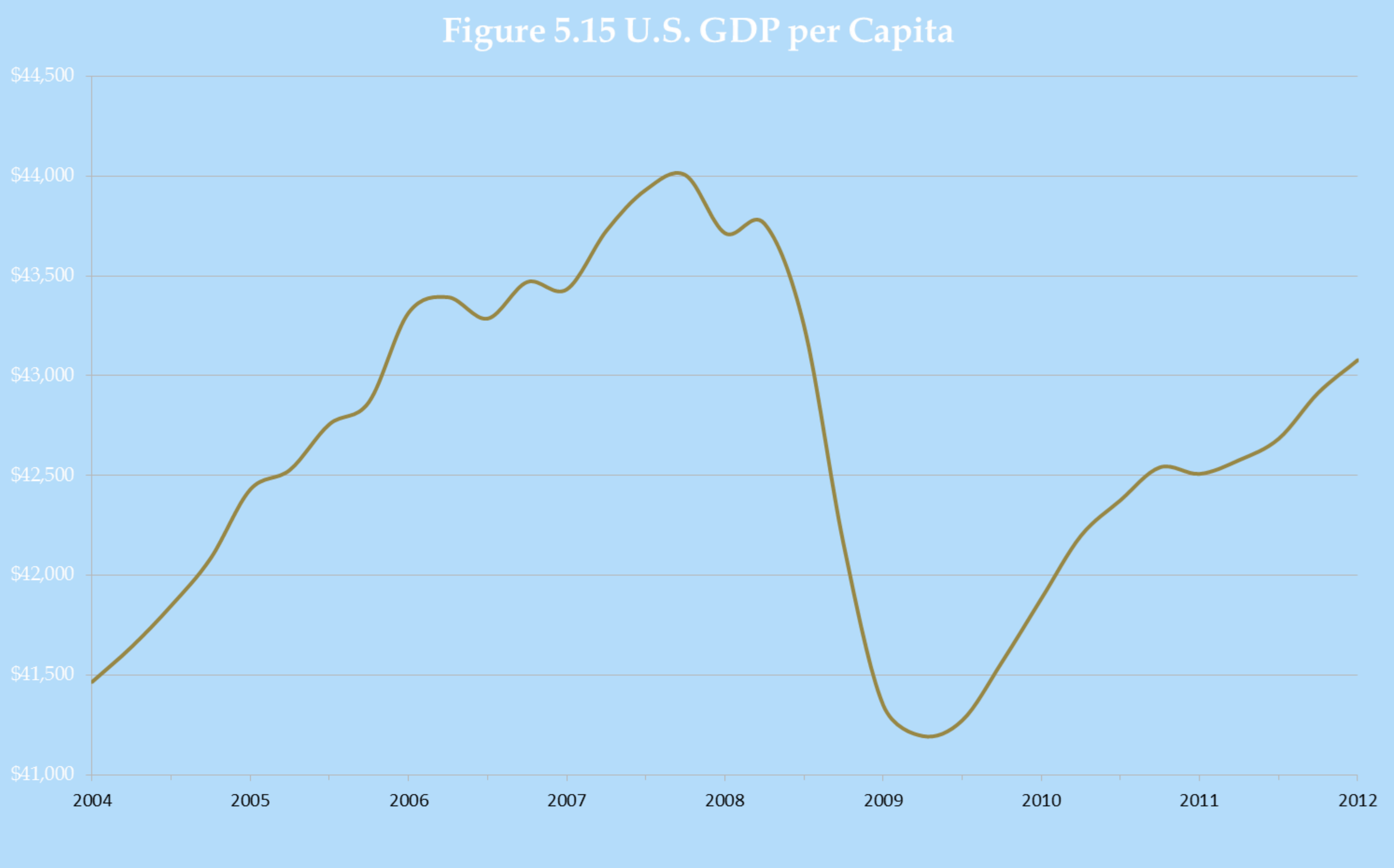
11) Economic theory inadequate to solve the crisis

12) Financial sector is like a cocoon, decoupled from the real economy.

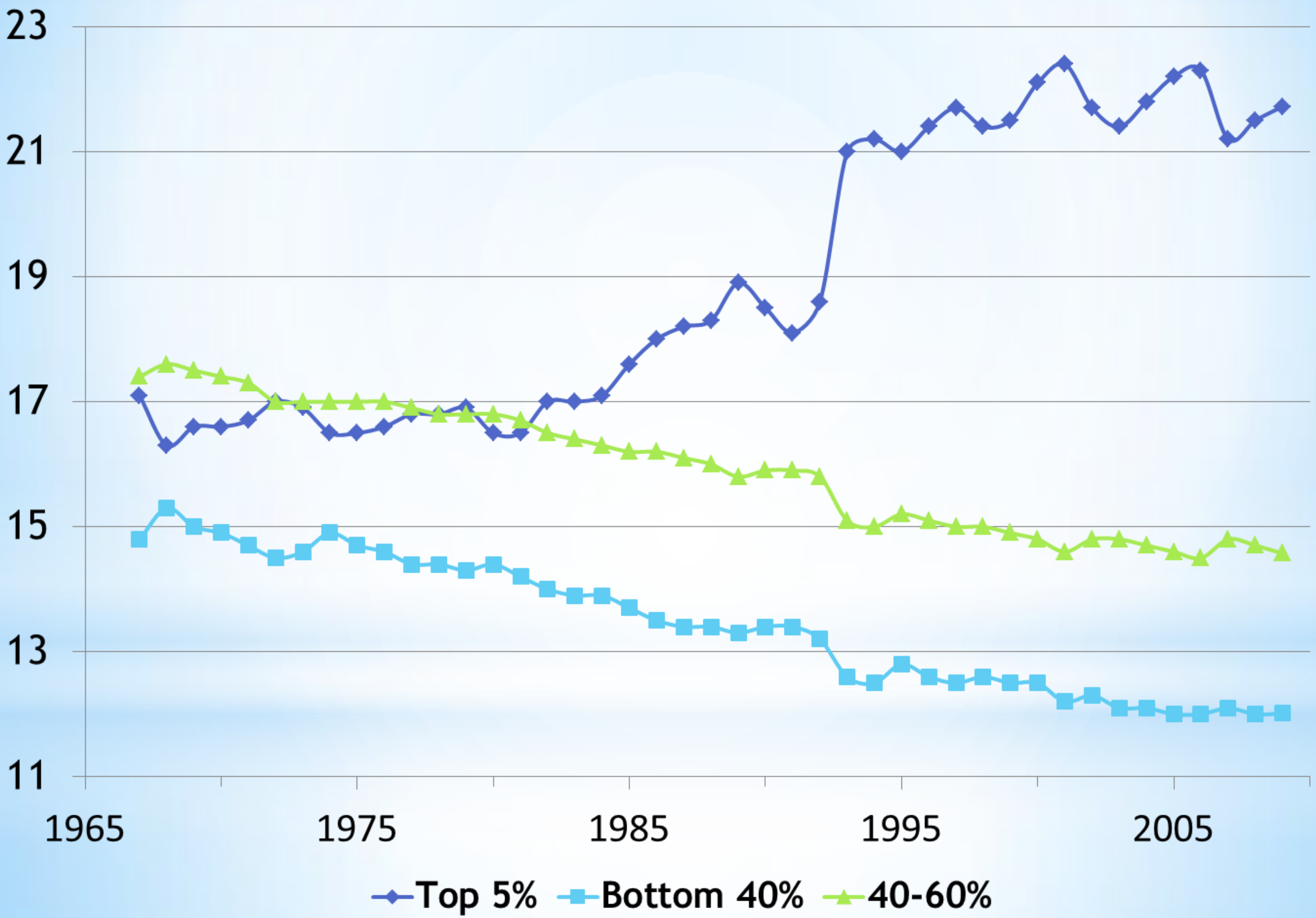
14) GNP decoupled from unemployment

13) Pres. Obama’s lack of experience

GNP per Capita USA



Trend in income distribution over time (Percent)



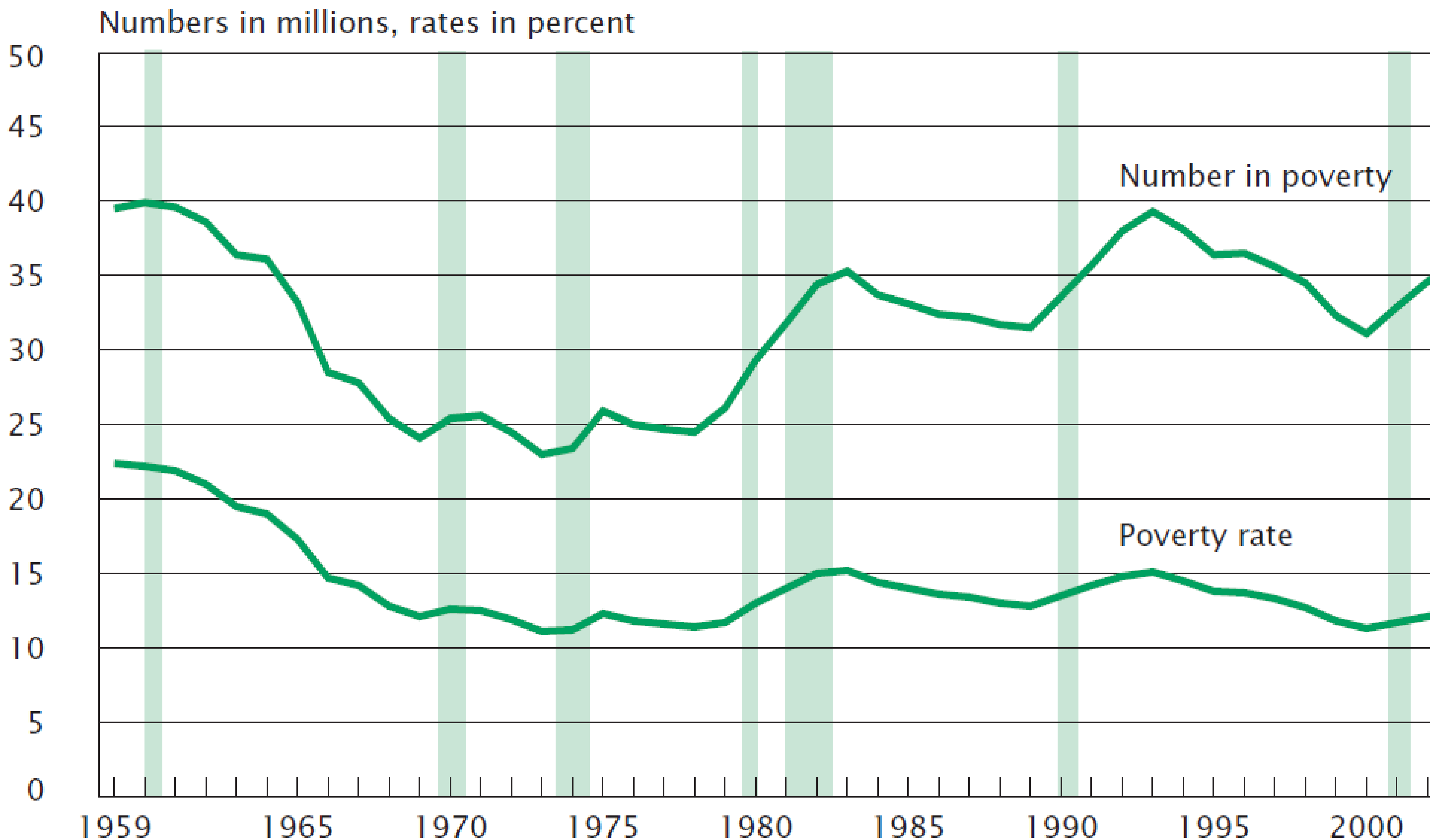
The tax returns of the superrich

% of all returns	Number of returns (000)	Total Income ($ Trillions)	Average $ income (000)	% of total income
Top 0.5%	730	1.1	1,507	14
Top 2.8%	3,900	2.0	513	26

Source: IRS

http://www.irs.gov/taxstats/indtaxstats/article/0,,id=96981,00.html

Figure 4.
Number in Poverty and Poverty Rate: 1959 to 2010



Note: The data points are placed at the midpoints of the respective years. For Information on recessions

Source: U.S. Census Bureau, Current Population Survey, 1960 to 2011 Annual Social and Economic Suppl

America's Socialism for the Rich

JOSEPH E. STIGLITZ

The Economists' Voice www.bepress.com/ev June 2009

Tearing up the social contract is something that should not be done lightly.

But this new form of ersatz capitalism, in which losses are socialized and profits privatized, is doomed to failure. Incentives are distorted. There is no market discipline. The too-big-to-be-restructured banks know that they can gamble with impunity—and, with the Federal Reserve making funds available at near-zero interest rates, there are ample funds to do so.

Some have called this new economic regime "socialism with American characteristics." But

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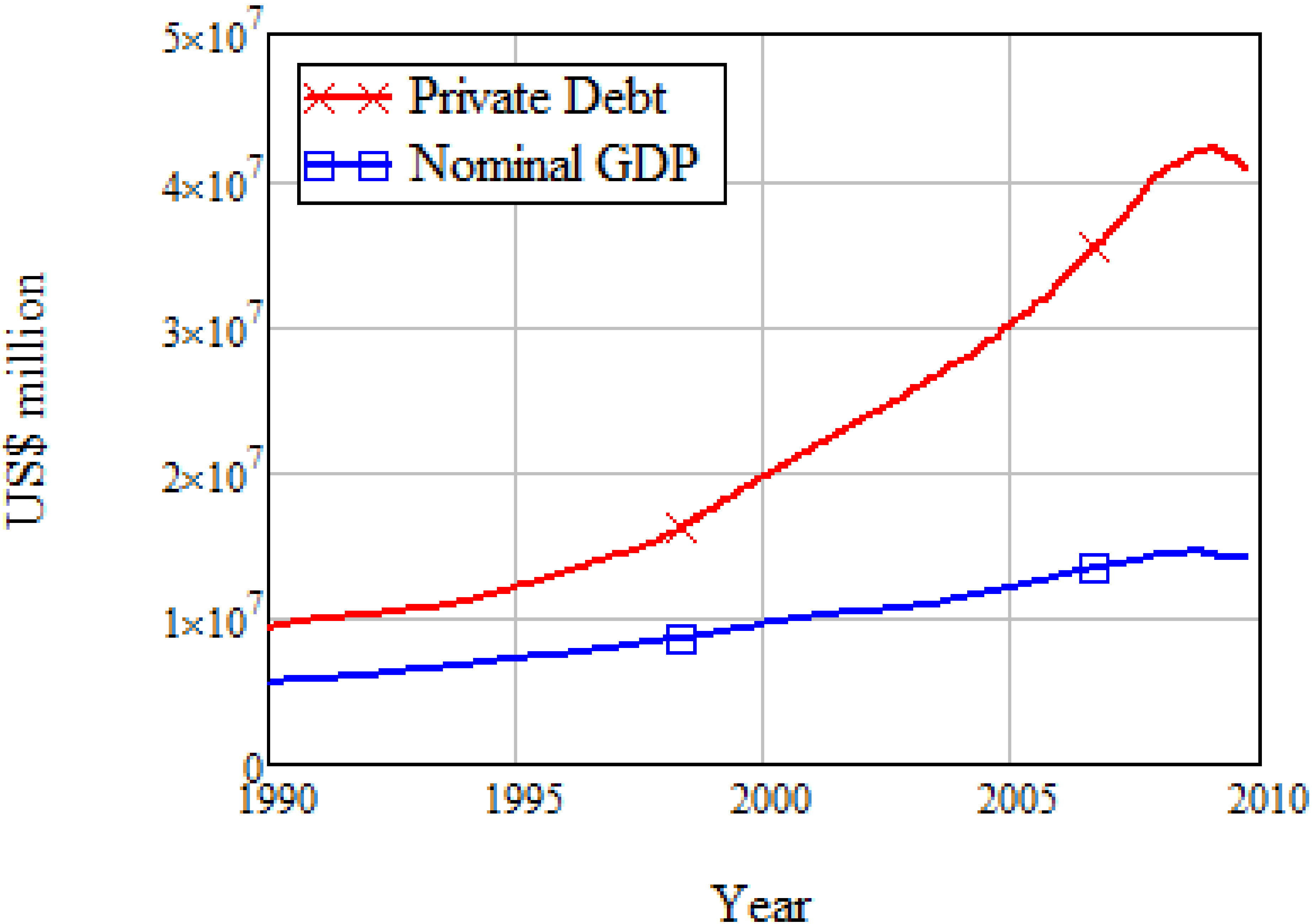
The selling of the bailouts:
We've "come back from the brink"

But we did so in the wrong way:
at a humongous cost &
at a great risk for the future.

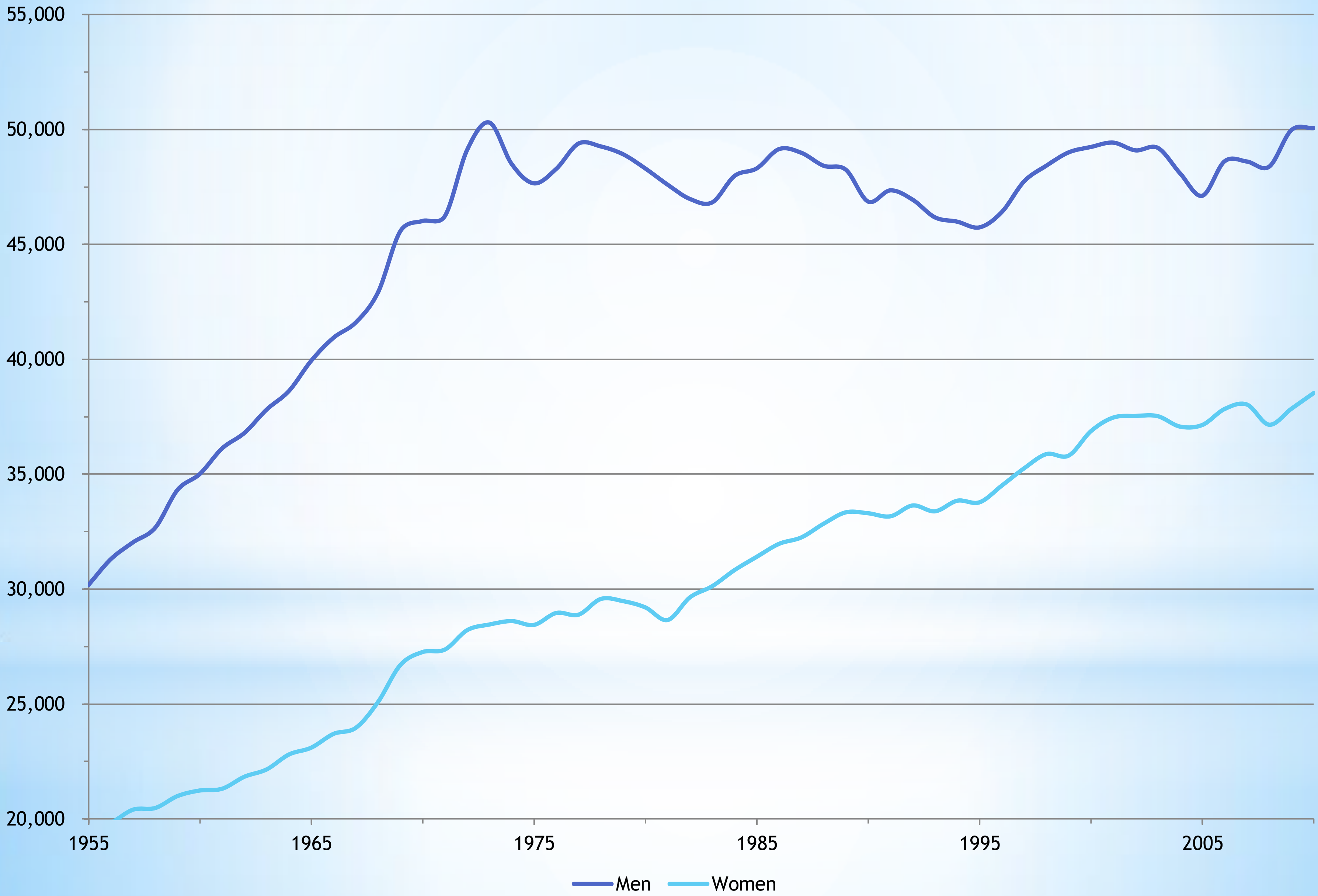
Krugman predicts a long road to economic recovery: we have a "sour economy"


Case Shiller National House Price Index
200
180
160
140
120
100
80
60
1983
1988
1993
1998
2003
2008
2013

the level of debt rose to levels far above that of GDP.



Median Income of Full-Time Year-Round Workers by Gender in 2010 Dollars




The End

For your attention

Questions and Discussion