

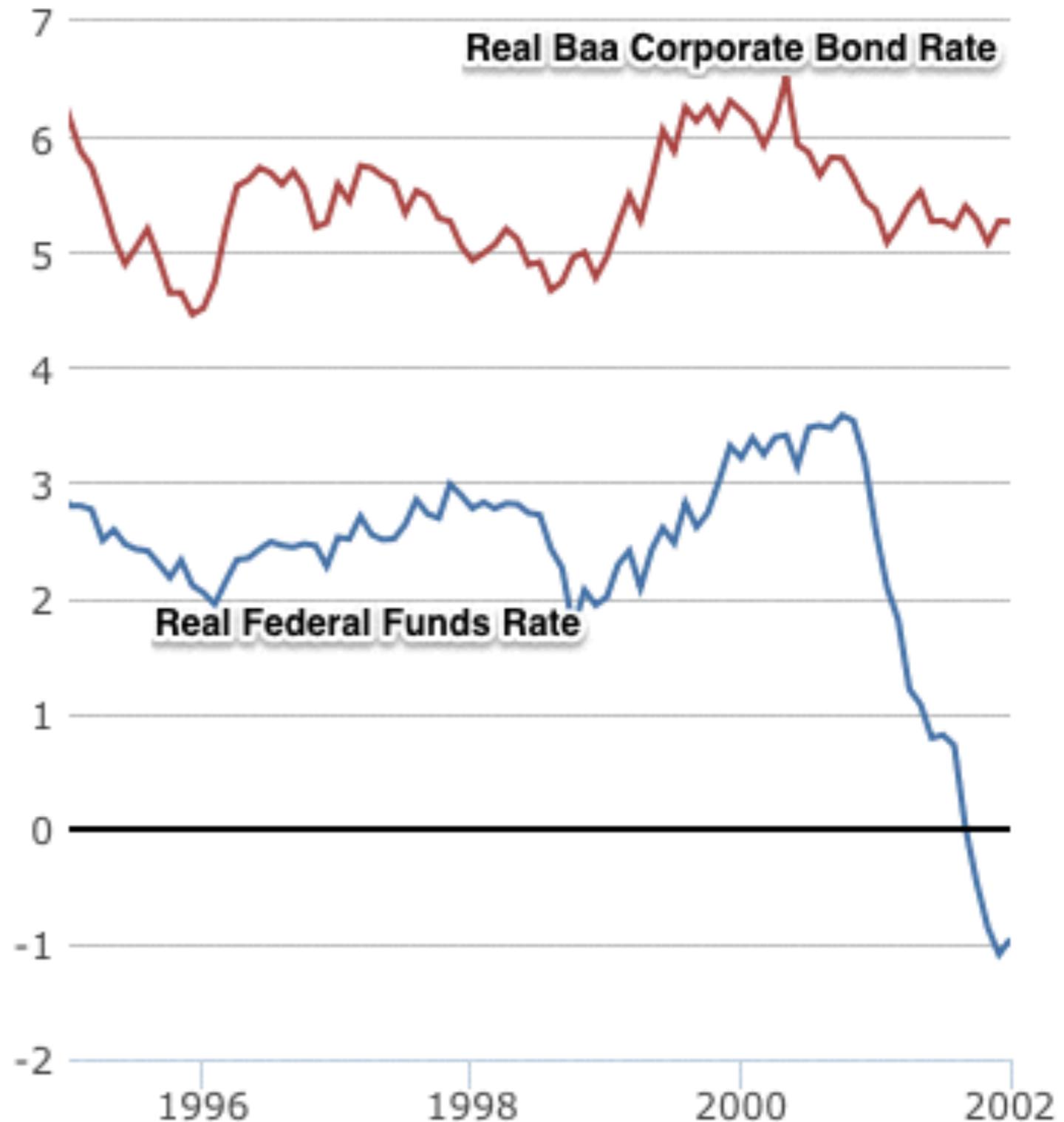
Principles of Economics
Macroeconomics

Origins of the Lesser Depression

J. Bradford DeLong
U.C. Berkeley

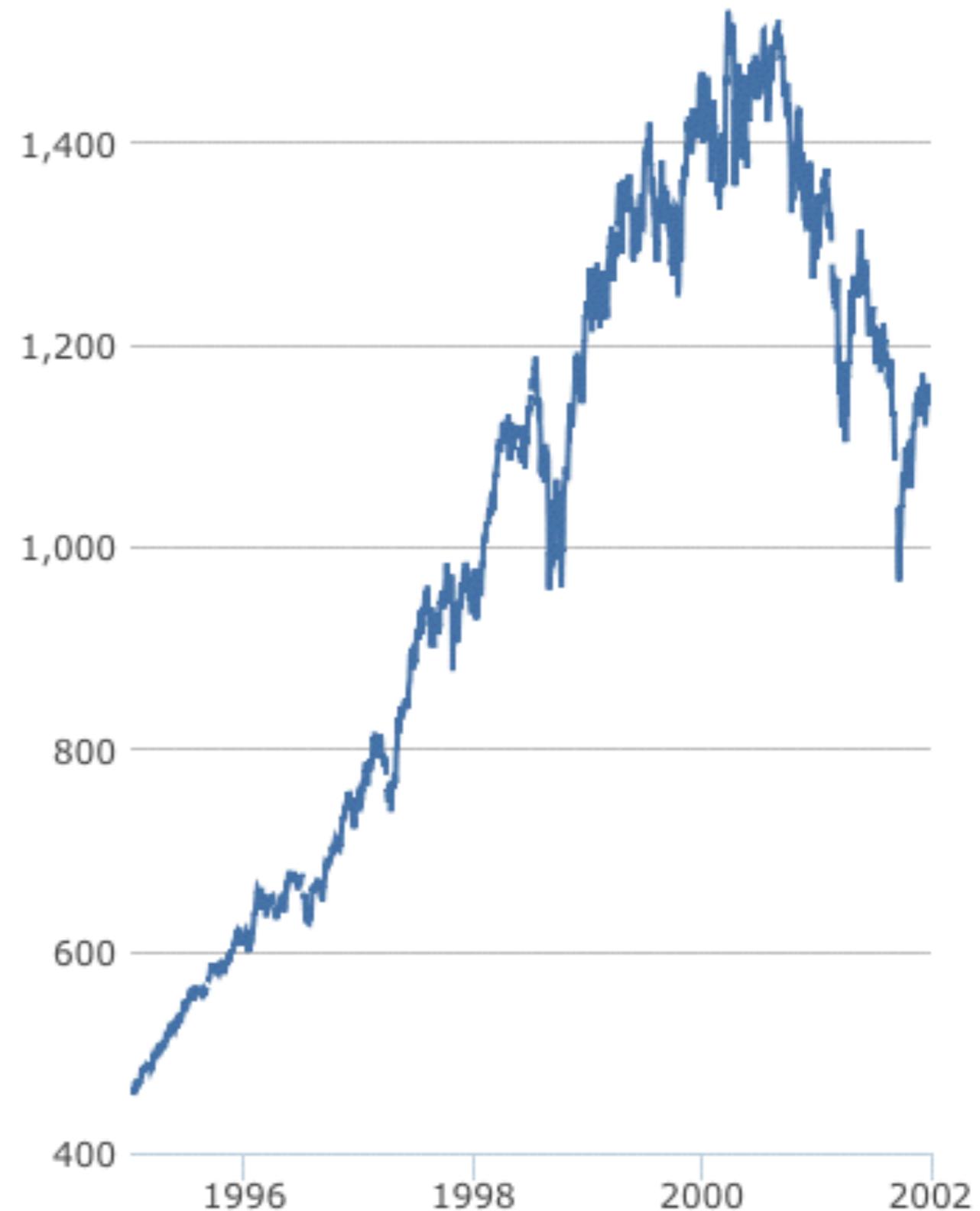
Interest Rates and Spreads, 1995-2002

- The Federal Reserve starts to punch the red button at the end of 2000
- Able to keep Baa real bond rates from rising
- Not able to lower them
- \$4T of fundamental losses in dot-coms



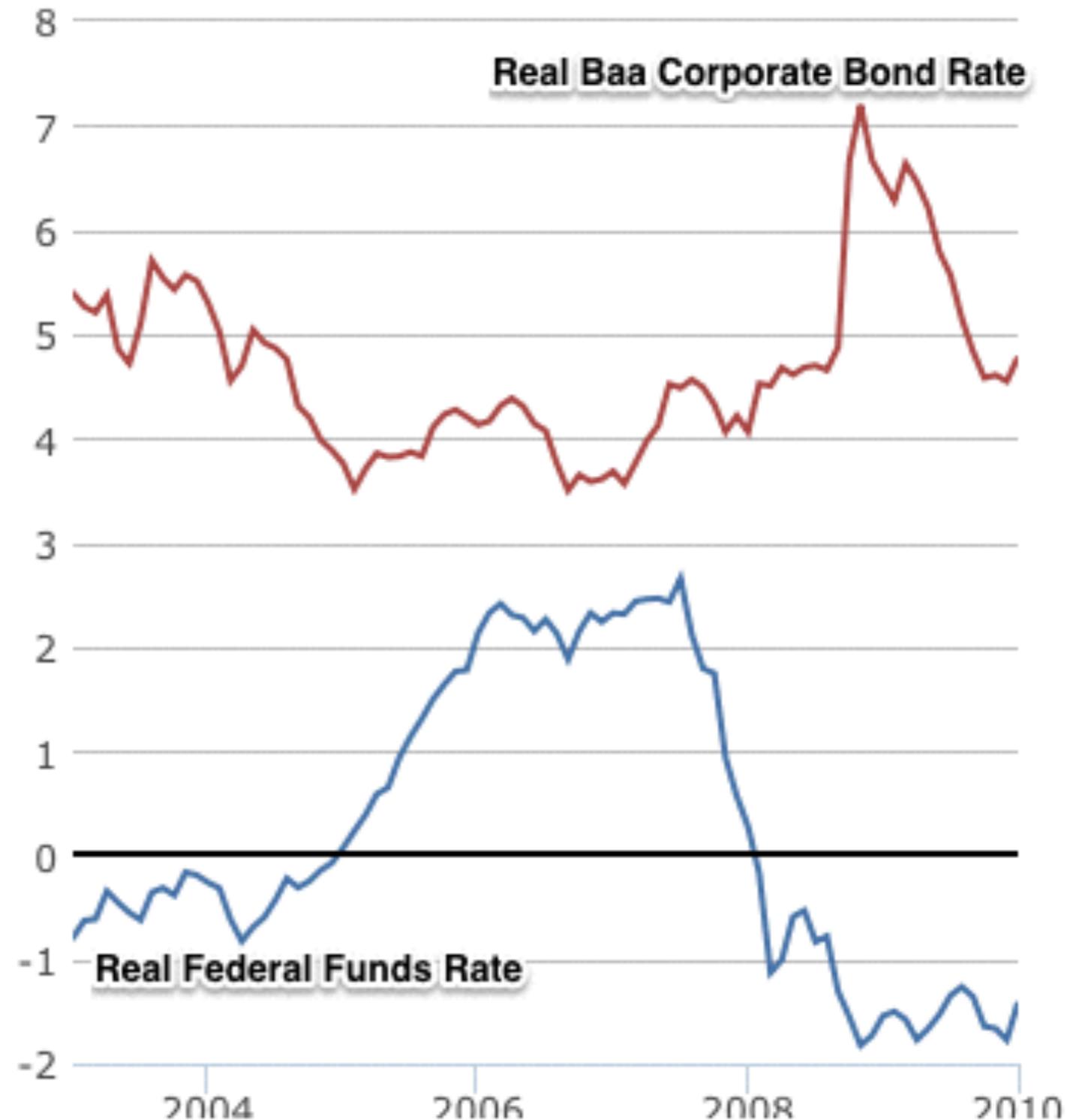
Stock Prices, 1995-2002

- Stock prices fall steeply with the collapse of the dot-com bubble
- But widening of interest-rate spreads not large enough to push up Baa borrowing costs
- And stock price decline limited to 20%



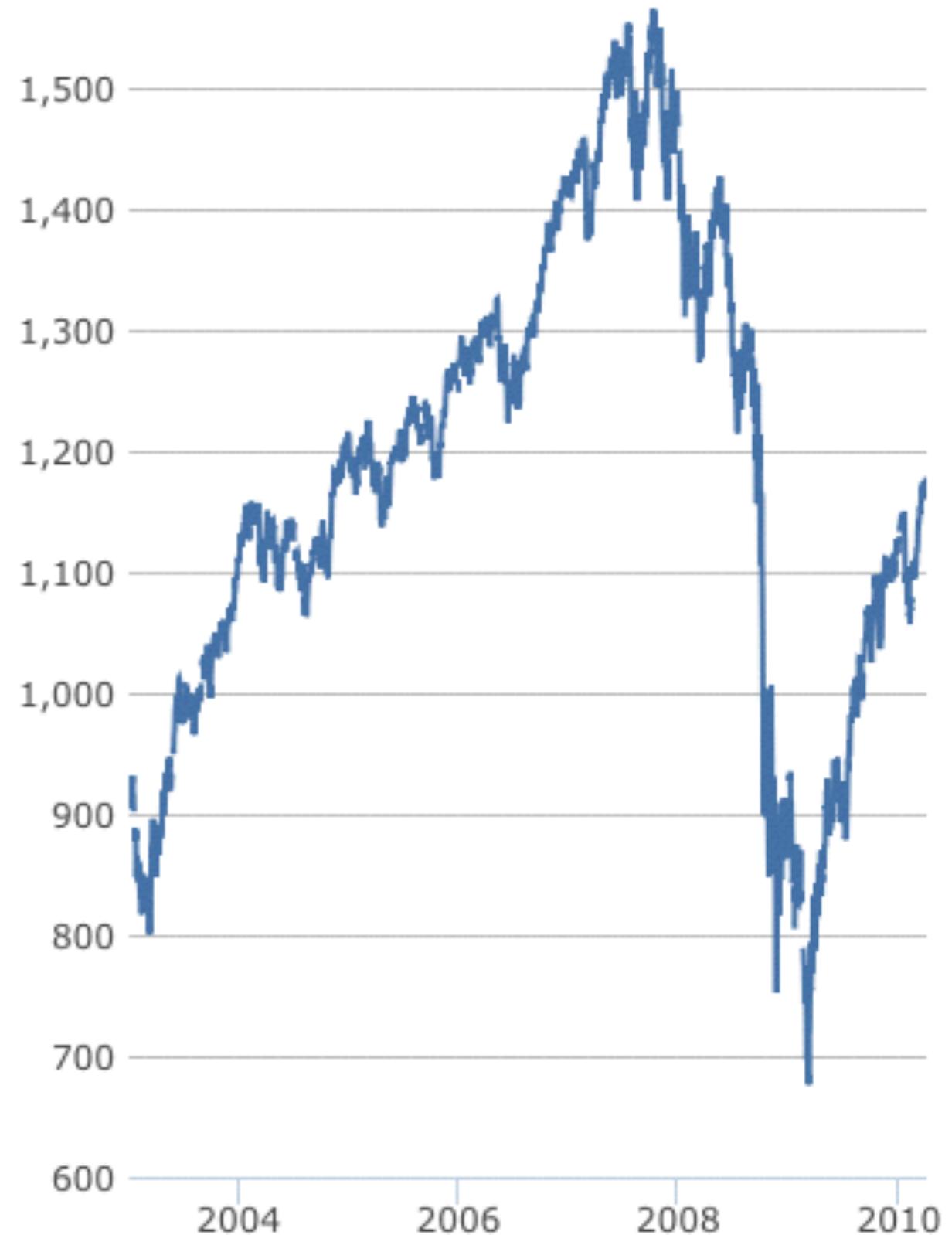
Interest Rates and Spreads, 2003-2010

- The Federal Reserve starts to punch the red button in August 2007
- Explosion of Baa bond rates in September 2008
- But \$500B as opposed to \$4T of fundamental losses



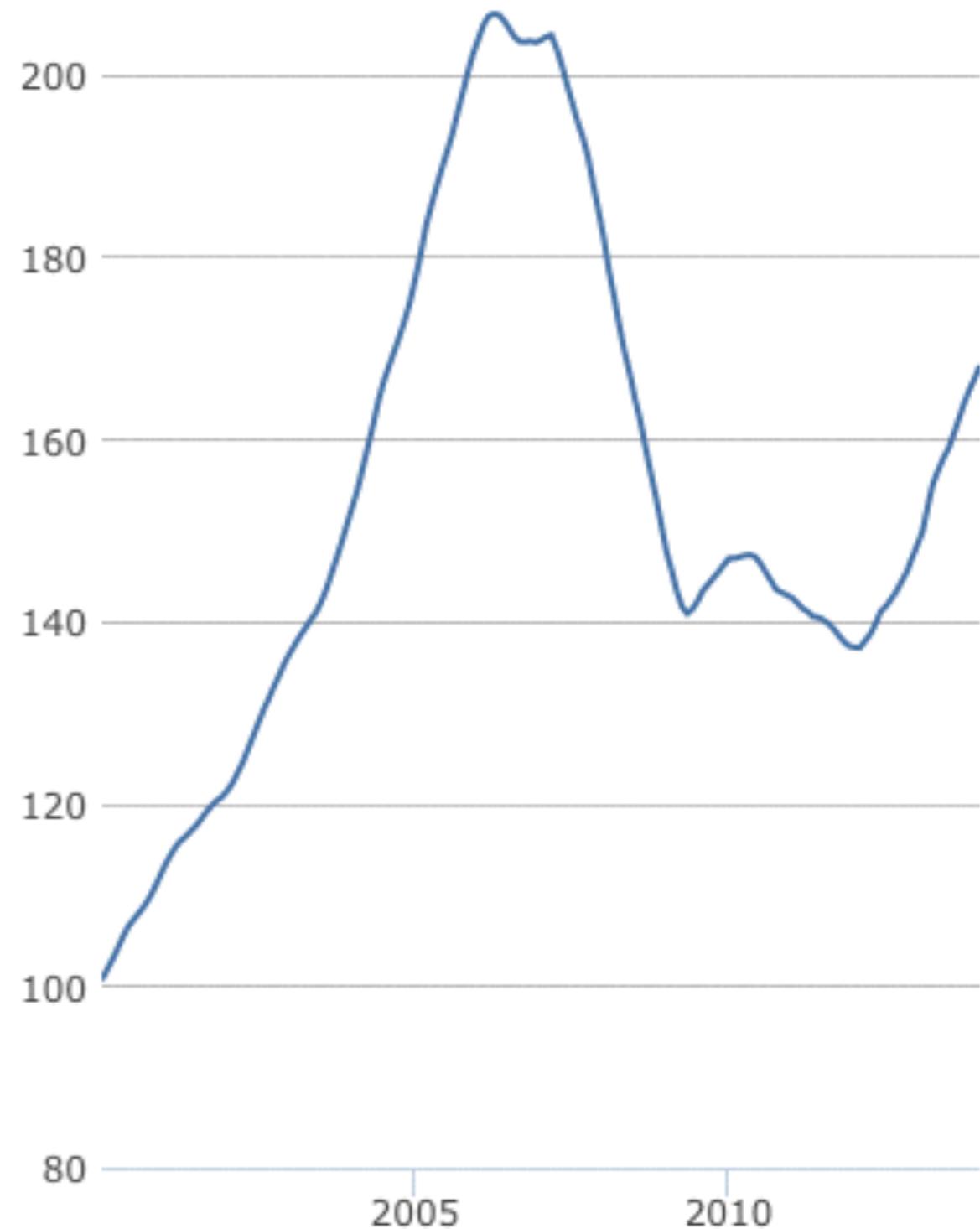
Stock Prices, 2003-2010

- Stock prices fall only by 15% until the Fall of 2008
- Then collapse: 50% fall in stock prices
- And widening of interest-rate spreads pushes up Baa borrowing costs



The Case-Shiller Housing Price Series

- Doubling of nationwide housing prices between 2000 and 2005
- Assumption that there could be substantial regional housing-price declines
- But not national housing-price declines
- MBS, CDO, AAA
 - Regulatory arbitrage...

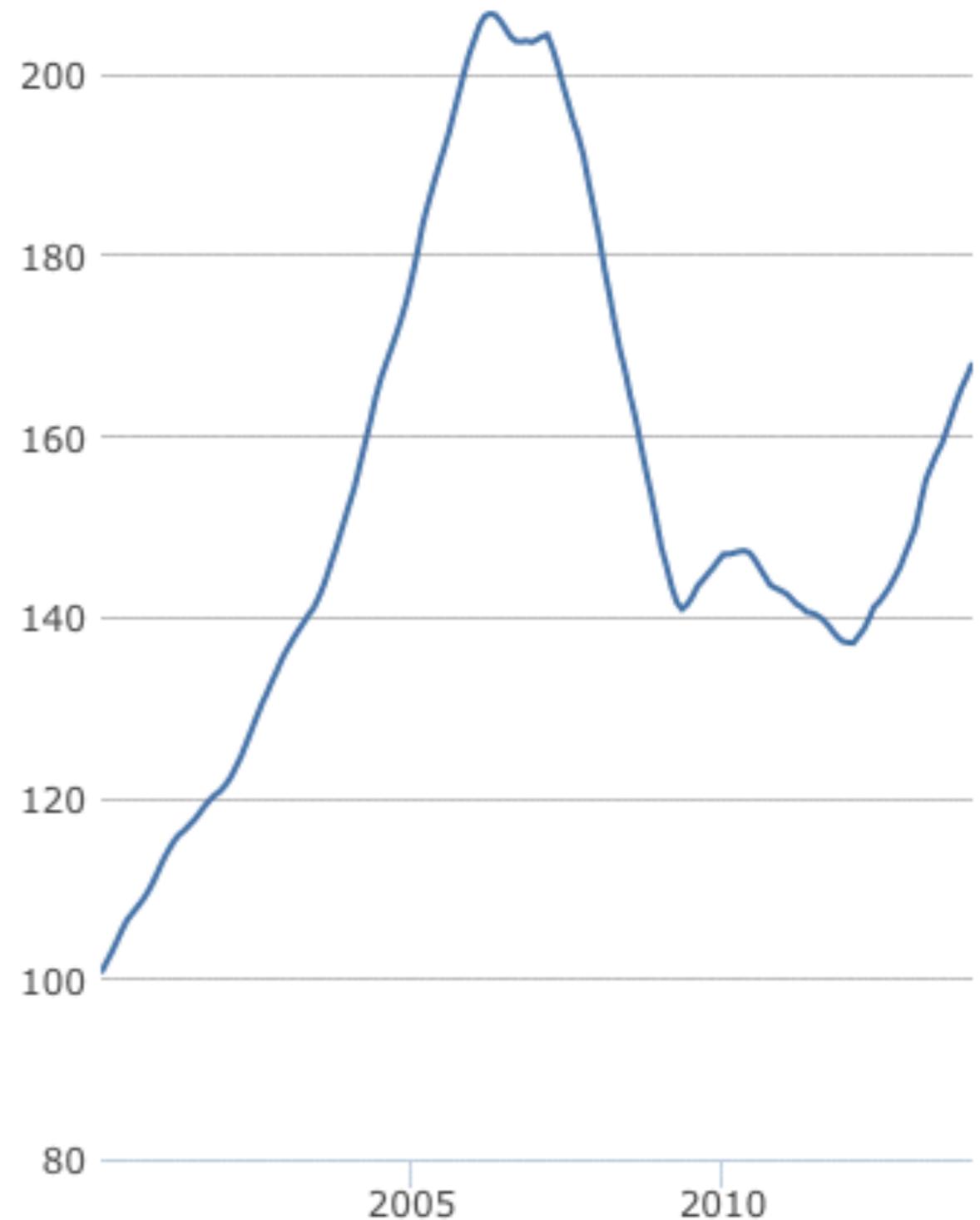


Managing the Financial Crisis

- Countrywide
- Bear Stearns
- Fannie Mae and Freddie Mac
- Lehman
- AIG
- Citigroup
 - “Liquidity Puts”
- Everybody else (save JPMC and GS)
- JPMC and GS
- TARP
- The Bagehot Rule
 - Lend freely
 - At a penalty rate
 - On collateral good in normal times
- Paulson and Geithner

Obama's Post-Election Dilemmas

- Monetary?
- Banking support?
 - Financial regulation?
- Fiscal?
- Long-term?
 - Entitlements...
 - Taxes...
 - Health care...
 - Climate change...
 - Inequality...
 - Mobility...



Safe Assets

- From Credit Suisse
- The disappearance of \$12 trillion of assets where “credit risk” had not been a concern
- And the investors are desperate to replace those assets...

Exhibit 174: Shrinking universe of “safe” assets in the primary reserve currencies (USD and EUR)

