The Macroeconomic Situation: June 2008

The Last Financial Crisis of the Nineteenth Century

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Friday’s Macroeconomic News
Sunday’s Macroeconomic News

- Tim Geithner, President of New York Fed
- A new regulatory framework…
- Covering commercial and investment banks, home and foreign…
- Federal Reserve to play “central role”
Monday’s Macroeconomic News

- Ben Bernanke, Chair of Fed
- Said the central bank will “strongly resist” any waning of public confidence in stable prices.
- CBOT futures: a 55 percent chance the Fed will raise the Fed Funds rate from 2 on Aug. 5 meeting (compared with 9 percent Monday morning); a 95 percent chance the Fed will raise by December (compared to 67 percent a week ago)
Inflation since 1964

- In the 1970s, jumps in inflation were followed within months by jumps in core inflation.
- Since 1982 not.
- The breaking of inflationary psychology?
- The breaking of unions with multi-year contracts and escalators?

- Prime Minister Robert Peel
- It should be illegal for the Bank of England to make emergency loans…
- If they make them in a crisis, we won’t prosecute…
- “Suspension” letters…
Karl Marx’s Critique

- Karl Marx
- You can’t solve a real-side problem—overinvestment, etc.—with financial manipulation
- “Peel himself has been apotheosized in the most exaggerated fashion... a massive accumulation of commonplaces, skillfully interspersed with a large amount of statistical data...”
Andrew Mellon Agreed with Karl Marx

- Andrew Mellon
- Hoover’s Treasury Secretary
- Hoover followed Mellon’s advice…
- Great Depression
- No Fed since has dared let key financial institutions fail
After the Depression, Hoover Did Not Like Mellon Much

Avoiding moral hazard

• Hoover: The “leave it alone liquidationists” headed by… Mellon… felt that government must keep its hands off and let the slump liquidate itself…. “Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate.” [Mellon] insisted that, when the people get an inflation brainstorm, the only way to get it out of their blood is to let it collapse… even a panic was not altogether a bad thing. [Mellon] said: “It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people”…

"Rescue be damned! Our conservative principles will see us through."

I love The New Yorker — for the wonderful writing, the reporting, the poetry — oh, who am I kidding? Like everyone, I start with the cartoons.
Implications: What the Fed and Treasury Are Doing

• Before the onset of the crisis, the Fed had direct holdings of around $790bn of Treasuries. As of Wednesday 28th May, the Fed’s liquidity operations had used over half of these ‘available securities’
• Unleashing FNMA to the tune of perhaps $500 billion…
• Guaranteeing the unsecured debt of every investment bank in the U.S.
• Liquidity tsunami…
Why the Liquidity Tsunami?

- Federal Reserve trying to maintain full employment
  - Without inflation
- Needs investment, demand for another leading sector with the housing collapse
- Fears Japan in the 1990s (let alone U.S. in the 1930s)
Additional Headwinds: Oil

- Dealing with the new oil shock
- Unlikely to be a “speculative” movement
  - Asian industrialization and demand simply proceeding too fast
  - A curb in U.S. demand that produces a fall in global oil prices will see U.S. demand rise again
Additional Headwinds: Oil and the Trade Balance

- The non-oil deficit is not that large
- Adjustment of the dollar against the Europeans has had a significant role
- But the oil deficit is large
- Hard to see how the dollar can avoid a big depreciation against Asian currencies…
We Are Not Through with This Dollar Cycle

- The dollar has fallen against the Europeans
- The dollar has not yet fallen against the Asians
- It may fall against the Asians in nominal terms…
- We may see a burst of wage inflation in Asia…
We Are Not Through with This Housing-Price Decline

- Housing prices don’t behave much like financial assets
- It takes a long time for supply-and-demand information to be incorporated into housing price declines
- Hard to see how we can avoid another 15%-20% decline in nationwide average housing prices…
Macroeconomic Outlook for Equities

- Long-run historical average of 20
  - With “normal” productivity growth corresponds to average real return of 5.5% per year
  - And to an equity premium of 4% per year
- Question of why it is so large
  - Today’s P/E suggest a percentage point lower for average real equity return
What Does This Mean for Asset Prices and Returns?

• J.P. Morgan: They will fluctuate…

• Global (and local) rebalancing
  – Asian appreciation
    • Implies domestic export and import-competing boom
  – U.S. housing sector declines
    • With consequences for financial institutions
  – Equities as a whole seem not unfairly valued…