

The Great Recession

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Objective

- Discuss the Great Recession, 2007-?
- What caused it, what made it last so long?
 - Why did so few people see it coming?
- Implications for World Trade and Policy.

Great Recession

- Big, by post World War II standards.

The 2007-2009 Recession in Perspective

	Output
2007-2009 Recession (2007 Q4-2009 Q3)	-7.2

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Great Recession

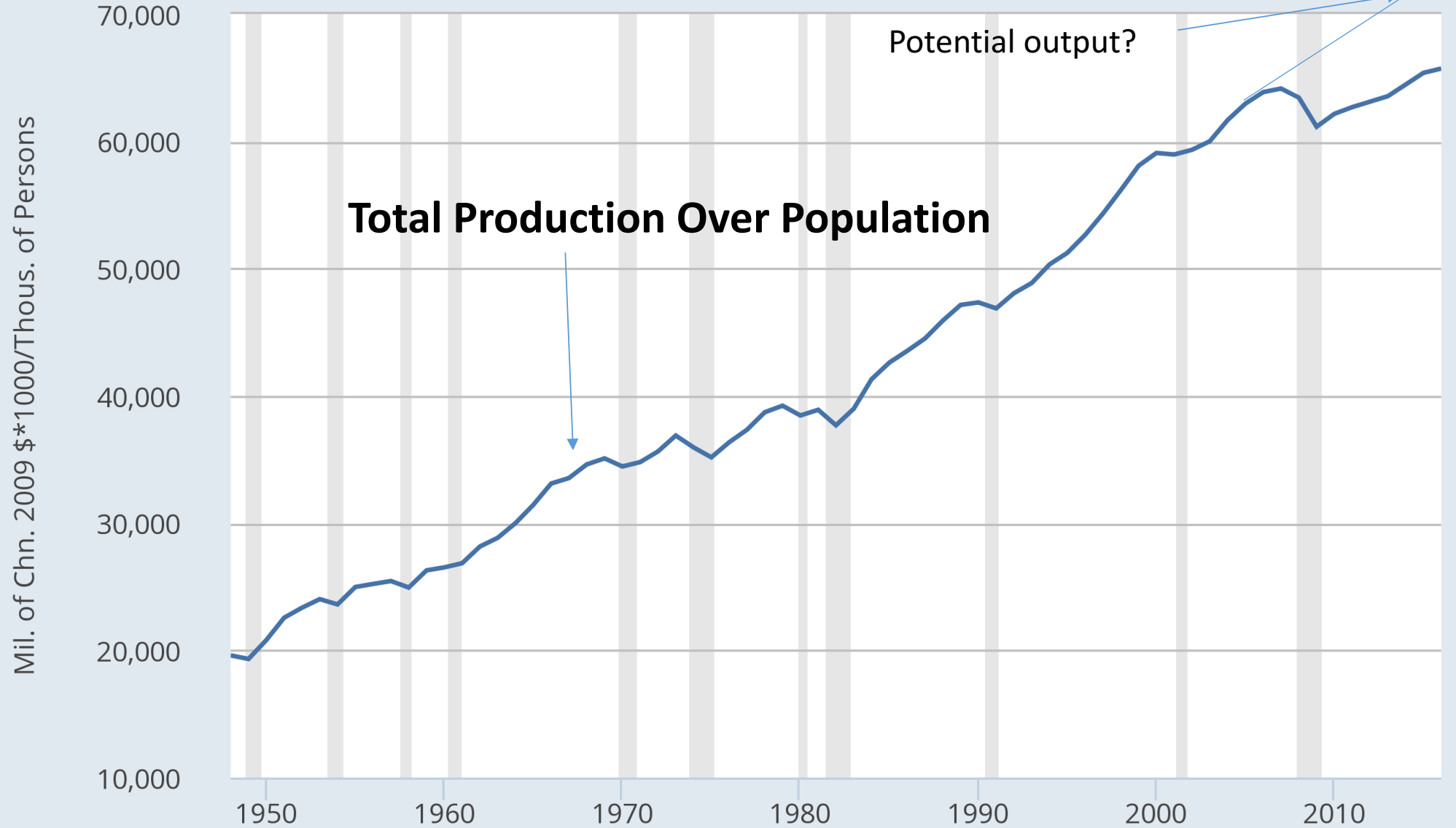
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The 2007-2009 Recession in Perspective

	Output
2007-2009 Recession (2007 Q4-2009 Q3)	-7.2
Average Post WWII Recessions	-4.4
US Great Depression (1929 to 1933)	-36

Christiano-Motto-Rostagno (2003)

Smaller than Great Depression.

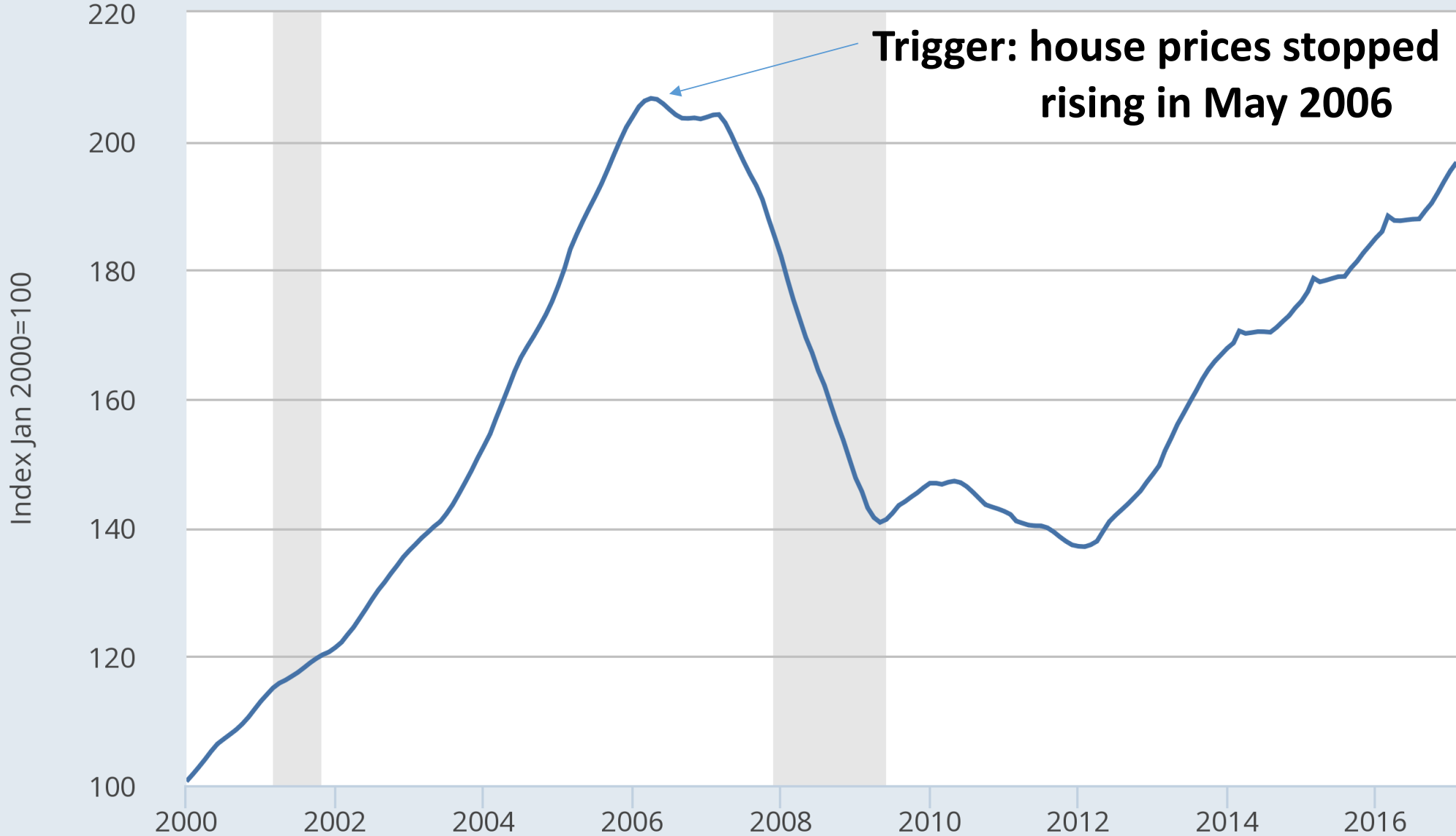


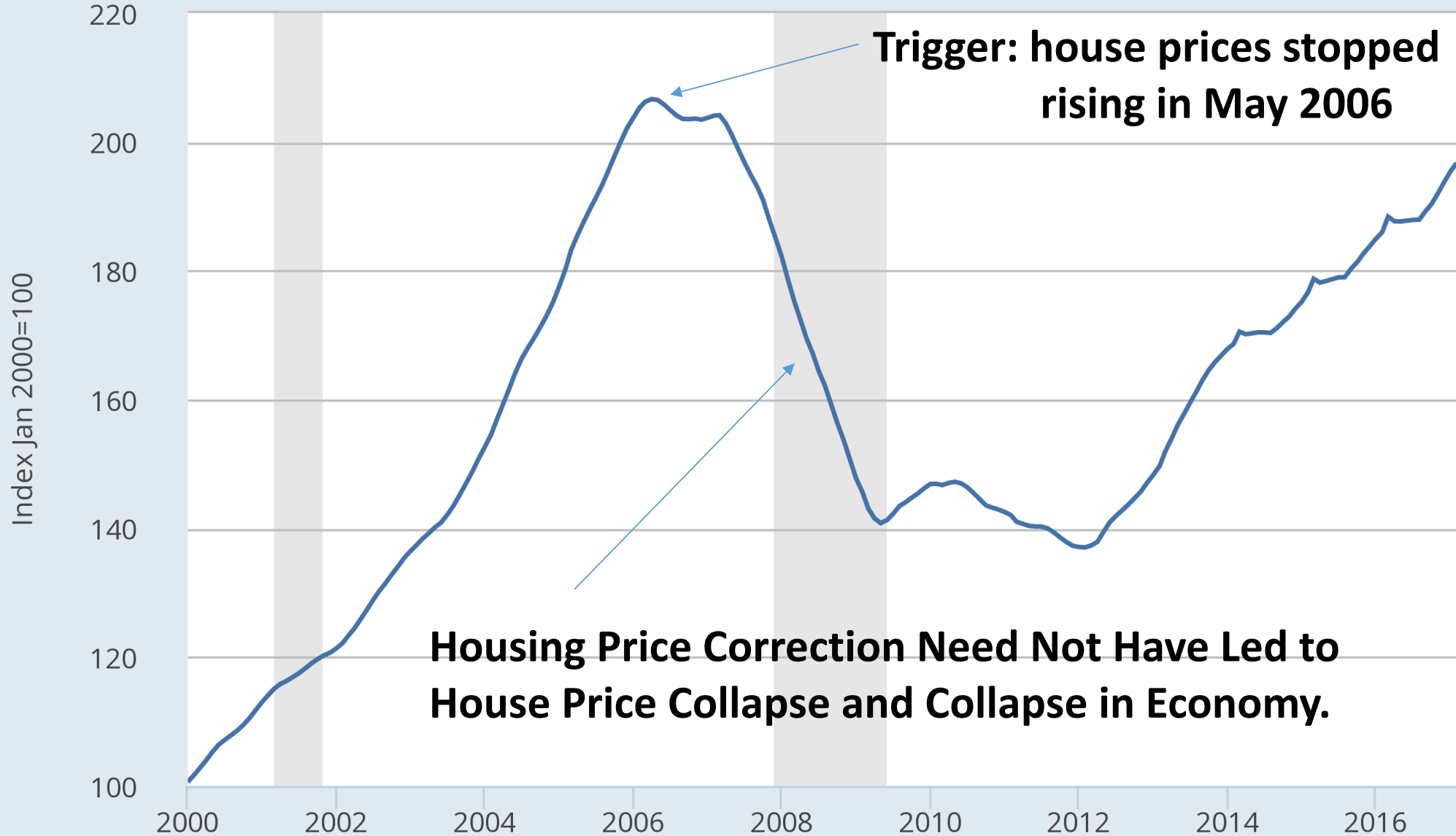
Great Recession: Why did it Happen?

- Initially, very puzzling....scary even.
- Overbuilding in real estate led to imbalances:
 - Unemployed construction workers looking for jobs.
 - ‘plenty of jobs (e.g., nursing), but unemployed (e.g., construction workers) didn’t have the right skills’
 - Problem: unemployment was high across *all* sectors.
- Obamacare:
 - Fear that ACA would raise costs of business led ‘wait and see’ attitude about firm investment and new hires.
 - Problem: Surveys of firms suggested that their main problems were ‘lack of sales’.

So, What Caused it...what was the trigger?

- Correction in Housing Prices in Mid-2006.
 - But, like Mrs. O'Leary's cow and Chicago fire, did not *have* to bring down the housing market and whole economy.





What turned the housing price correction into a disaster?

- Housing price correction led to bank run.

This is what a bank run looked like historically.

This time, bank runs were invisible to most people (Gorton).

Run was on *Shadow Banking System* not commercial banking system.

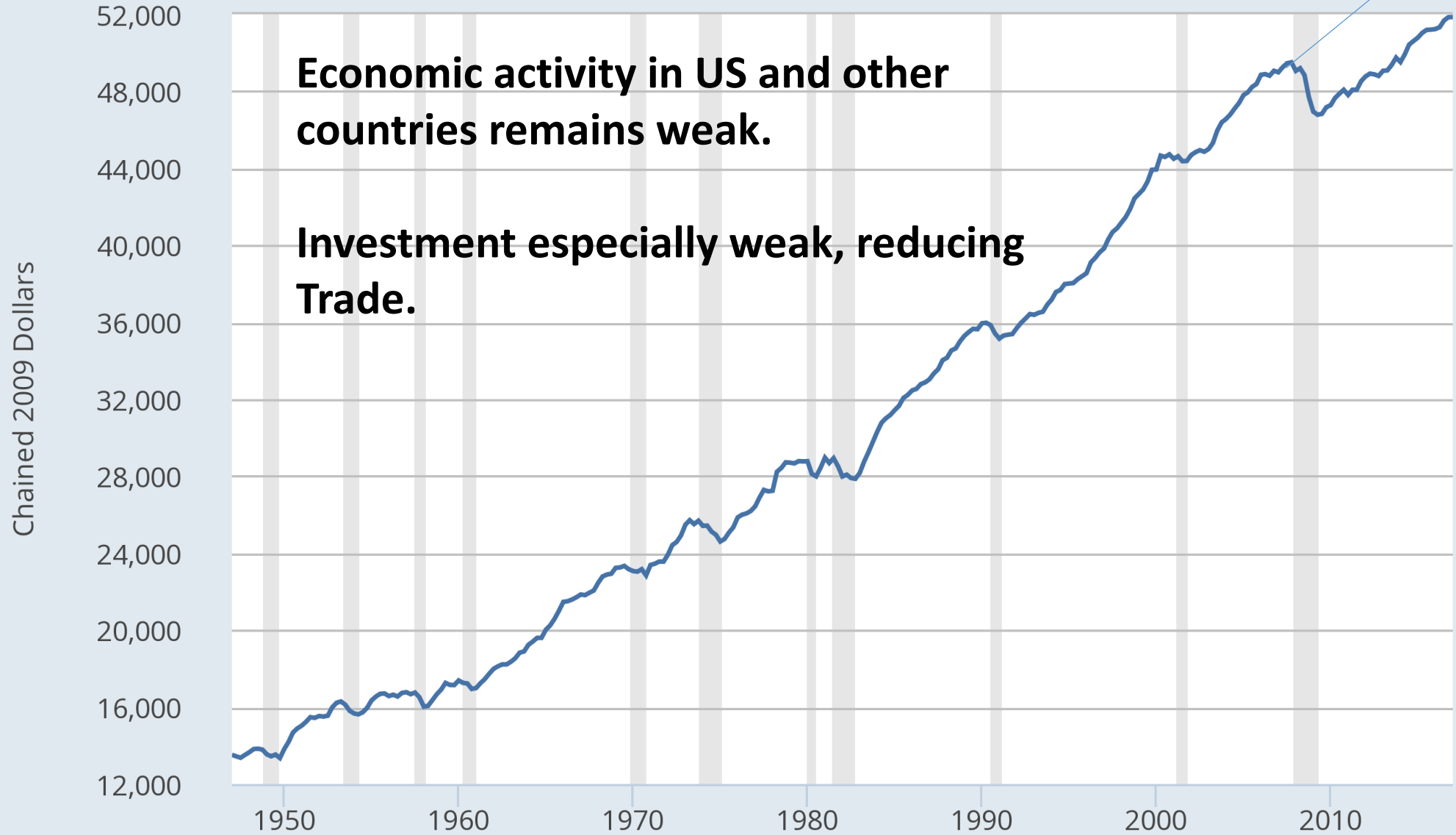
It was not generally known how huge the Shadow Banking system was and how Vulnerable the Shadow Banks were.



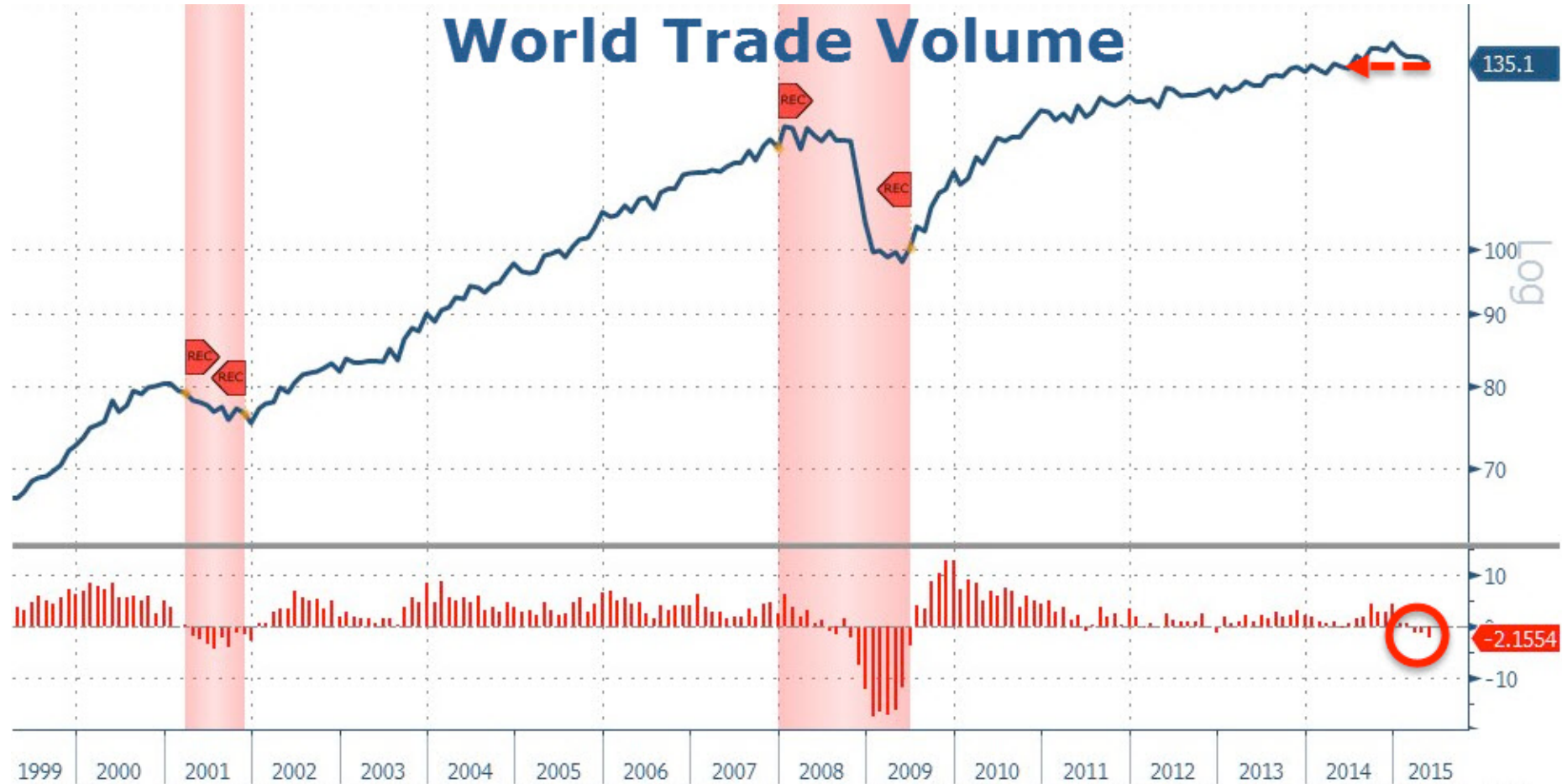
Why did it last so long?

- As credit to housing sector dried up, housing prices fell sharply.
 - Fall in housing prices made homeowners feel poor, and cut back spending.
 - Firms seeing fewer sales, cut back investment.
 - Economy in a tailspin.
- Perfect storm: standard solution to recession could not be implemented when interest rates hit zero.
 - A big infrastructure program might have helped.

What about trade?



Trade has slowed down with relative weakness in US, Chinese and other Economies. Also, World Trade Organization Reports that trade restrictions are on the rise.



Implications for Policy

- A bank run turned what could have been a relatively small housing correction into a major disaster.
- The problem was not so much in the commercial banking system.
 - Indeed, the commercial banks acted as 'shock absorbers' for the system.
 - 'Too big to fail' and 'lax lending standards' in banks not the first order of business.
- The problem was the shadow banking system.
 - It was vulnerable to runs because it had no protection from a central bank.
 - Must be careful to spot bank-like institutions and make sure they are not vulnerable to runs.

Banking Crisis, the 'The Panic of 2007' (Gorton)

- Example of a Bank:
 - bank takes a \$1 deposit and promises to repay \$1 in one period.
 - It lends the money to a firm, which promises to pay the \$1 back in *two* periods (zero interest!)
 - *Maturity mismatch.*
- If depositors at *one* bank want money back....
 - Bank can *roll over* liabilities
 - Bank can sell assets to another bank.
- If depositors at *all* banks want money back...
 - Rollover crisis.
 - Banks must sell assets outside industry where assets are not well understood.
 - Must sell at a loss (firesale).

Rollover Crisis: Role of Housing Market

- What matters is the actual value of assets and their firesale value.
- If bank is solvent under (firesale value), then probability of run is zero.

Pre-housing market correction

Assets	Liabilities
120 (105)	Deposits: 100
	Banker net worth 20 (5)

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Post-housing market correction

Assets	Liabilities
110 (95)	Deposits: 100
	Banker net worth 10 (-5)

- Rollover Crisis Hypothesis:
 - pre-2005, no crisis possible,
 - post-2005 crisis possible.