

PEARSON



Principles of Economics & The Economic Outlook

With Guest Speakers

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Question & Answer – (Answers by R. Glenn Hubbard & Anthony P. O'Brien)

1. **From Brian Fikkert:** *“The government has made the argument that taxpayers will not really have to take on the full cost of the \$700 billion bailout because the assets that are being acquired will appreciate over time. But if these assets are such a great investment, wouldn't the private sector be willing to purchase these assets, removing the need for the government bailout?”*

- **Guest Speakers Response:** “Great question. The bailout seems to have two objectives: restoring liquidity to markets that are currently frozen and providing capital to banks. Using the bailout to purchase mortgages and mortgage-backed securities from financial institutions may help the first objective, but does little for the second. This is one reason Secretary Paulson has begun talking about using some of the funds to buying preferred shares in banks rather than using all the funds to buy mortgage-related securities. You are correct that if the reverse auctions yield prices at the level that private investors would have been willing to pay, then it is difficult to see the point. The argument that the auctions may help revolves around the lower risk aversion of the Treasury and, perhaps, its longer time horizon allowing it purchase these assets for prices above what they could be sold for to private investors but below what their market value would be when the financial system revives. The hope is that this revives trading in these assets by showing potential buyers that a secondary market in these assets does exist.”

2. **From Michael Greene:** *“Are credit default swaps the most dangerous element of the current meltdown?”*

- **Answered during chat.**

3. **From Pete Williams:** *“With regard to the various responses by different central banks in Europe and around the world, does the current crisis provide an opportunity for a natural experiment that will aid the development of macroeconomics, or will the inter-related nature of international credit markets prevent comparison of the relative successes of each country's solution?”*

- **Answered during chat.**

4. **From Dennis Leyden:** “... For a micro principles course, given that we don't have most of the macro material as foundation, do you think that raising this issue can be treated appropriately? If so, how?”

- **Answered during chat.**

5. **From Pete Crabb:** “Is a loan able funds model useful in teaching about this financial crisis?”

- **Guest Speakers Response:** “Yes, the loan able funds graph (Hubbard and O’Brien, Ch 21 of Economics and Ch 9 of Macroeconomics) can be useful. Clearly, the demand for loan able funds has shifted to the right, while the supply has shifted to the left to a greater extent, driving up the equilibrium interest rate and reducing the equilibrium level of loan able funds. The model needs to be supplemented, though, because it assumes that the loan able funds market is functioning normally. So, it might be a good idea to also discuss how information problems – which many investors believe have become severe in the markets for many types of securities – can keep the loan able funds market from working efficiently.”

6. **From Don Mathews:** “Thank you, Glenn and Tony.”

- **Guest Speakers Response:** “Thank you Don!”

7. **From Claudia Quintana:** “Do we really need to panic about the economic crisis? Are we going into a similar Great Depression?”

- **Answered during chat.**

8. **From Justin Wang:** “How do we ensure that all the liquidity the Fed is injecting is staying in the US and not being invested in foreign countries?”

- **Guest Speakers Response:** “Good question. At this point, I don’t think the Treasury and the Fed are worried about the ultimate destination of these funds, providing they can achieve their objective of unfreezing financial markets. Looking directly at the Fed’s actions, the huge increases in reserves in U.S. banks seems to be indicating that the funds are staying close to home – probably too close to home in that interbank lending continues to be frozen.”

9. **From David OHara:** “What do you think of the Treasury's plan to take an ownership stake in banks?”

- **Guest Speakers Response:** “The Treasury plan should focus on recapitalizing banks and other financial institutions in order to lower the cost of credit intermediation in the economy. The most efficient and quickest step would be direct capital injections through preferred stock. (The recently passed legislation permits the Treasury to do this, though Secretary Paulson and Chairman Bernanke did not favor this approach.) Think of Warren Buffett’s investment in Goldman Sachs as a prototype.”

10. From Patrick Becker: *“What are your thoughts of the current bailout plan.... will it work?”*

- **Guest Speakers Response:** “Restarting the financial system and lowering the cost of credit intermediation requires three bold policy actions: (1) action by the Federal Reserve to provide ample liquidity and ensure the smooth functioning of the interbank lending market, (2) action by the Treasury to recapitalize financial institutions, and (3) action by the government to blunt falling house prices in the presence of a high cost of credit intermediation. Properly executed, the Treasury plan will be an important contributor to such a “shock and awe” approach to rekindle confidence in the financial system.”

11. From Jorge Medina: *“The fed recently decreased the fed funds rate. What was the purpose of this action?”*

- **Guest Speakers Response:** “The cut in the federal funds rate earlier this week was meant to serve the usual purpose of these cuts: pumping more reserves into the banking system and reducing the cost of lending. Unfortunately, under current conditions, banks aren’t doing much with their increased reserves and the link between the federal funds rate and other market interest rates has largely broken down. Longer term interest rates – mortgage rates, corporate bond rates – have been rising, rather than falling. So, it does not appear that cutting the federal funds rate is likely at this point to have its usual stimulative effect.”

12. From David Allardice: *“Why has policy been so ineffective? In the past history - actions of the dimensions taken would have had a major impact. Today the dow is below 9,000 - so actions are not impacting market confidence.”*

- **Answered during the chat.**

13. From Chris Kuiper: *“How much is the current problem due to liquidity and how much is due to a confidence problem in the markets? Should the Fed do something about confidence or can they?”*

- **Guest Speakers Response:** “The problem is not so much liquidity – the absence of funds to spend – as the lack of buyers in many financial markets. Presumably, the lack of buyers indicates a lack of confidence. This lack of confidence takes two forms: There is a lack of confidence that loans being made – even if the maturity is very short – will actually be repaid – so called counterparty risk. But there also seems to be a lack of confidence in policy, so that investors are not so sure that the crisis will end any time soon and so are reluctant to buy. We are seeing this on the stock market, where it appears that investors have decided that there is non-negligible chance of a 1929-style meltdown and is passing up what would have appeared to be bargain prices just a few weeks ago.”

14. From Sarah Ghosh: *“When do you think the credit crunch will relax? Also, will all these bank failures strap FDIC?”*

- **Guest Speakers Response:** “If only we knew! At this point, it is safe to say that the crisis will not end until confidence is restored. Restoring confidence is the tricky part, of course. The Federal Reserve and the Treasury have taken unprecedented actions that one might have thought would reassure investors that a catastrophic meltdown will not occur. However, it is pretty clear that to this point investors are not buying it and confidence in policy seems very low. The FDIC has been able to fund the bank failures we have seen so far. The bailout bill gave the FDIC additional authority to borrow from the Treasury should additional bank failures sap the FDIC insurance fund.”

15. From Wayne Gineo: *“What do you think of the plan laid out by John McCain to buy out consumer mortgages?”*

- **Guest Speakers Response:** “Senator McCain rightly pointed to falling house prices as a critical factor in the current prices. His plan would help millions of struggling homeowners, but would do little to accomplish the objective of blunting falling house prices. An op-ed in *The Wall Street Journal* by Glenn Hubbard and Chris Mayer illustrated an alternative, more comprehensive approach.”

16. From Michael Salemi: *“Now that the Fed, Treasury, Congress and Executive Branch have shown that taxpayer funds are required to restore the flow of funds, what sorts of regulation of financial firms should be added to avoid the creation of moral hazard?”*

- **Guest Speakers Response:** “We are likely to see major changes in financial regulations as a consequence of the financial crisis (a familiar pattern in U.S. financial regulation). Topics of capital requirements, regulatory arbitrage, supervision, and overall regulatory structure (that is, the possible emergence of a super-regulator in the United States, as in the United Kingdom) are likely to take center stage.”

17. From Chelsea Rutherford: *“What are the top reasons, why or why not, that the bailout will or will not work?”*

- **Guest Speakers Response:** “See answer to question 10.”

18. From Enrique Lopezlira: *“In hindsight, was repeal of the Glass-Steagall Act a mistake? For example, would AIG be in trouble if the act was still in place?”*

- **Answered during chat.**

19. From Mark Ratta: *“I find it difficult to imagine that the people at the top of the mountain couldn't see this coming from their perspective. Isn't the power elite buying everything dirt cheap at this point? Isn't this what happened during the great depression? And wasn't the great depression created by the magnates toward that end? What about this time?”*

- **Guest Speakers Response:** “There certainly were people who gained during the Great Depression if they were savvy enough to buy when asset prices were beaten down. John Maynard Keynes, the father of macroeconomics, made a great deal of money by investing in the U.S. stock market in 1932. That said, there is no evidence that I know of that either the Great Depression or our current difficulties were somehow engineered by insiders to help them profit from falling asset prices. Both in the 1930s and now there are a lot of insiders who have lost their shirts.”

20. From Don Mathews: *“How would you teach principles students about the way financial difficulties spread from institution to institution. The other day, one of my students asked, “When a bowling alley fails, no other bowling alleys fail. Why is it that when a bank fails, other banks might fail as a result.” How would you answer that question? Thank you very much.”*

- **Answered during chat.**

21. From Edward Monkman: *“Is pushing on a string relevant to the liquidity trap given today's lowering of rates?”*

- **Guest Speakers Response:** “Yes, somewhere John Maynard Keynes may be nodding in recognition of our current difficulties. In the current situation, it appears that the Fed can provide as much liquidity as it wants without having much effect on either long-term interest rates or, more generally, the willingness of financial institutions to invest or investors to buy securities.”

22. From Claudia Quintana: *“How the people will be affected by the \$700 billion bail out?”*

- **Guest Speakers Response:** “Depends on whether it works. If it succeeds in restoring confidence in the financial system and unfreezes the markets for certain securities, then nearly all of us will be affected. As we discussed during the chat, most of us are dependent on borrowing from banks when we buy cars or houses, or when we apply for student loans. If the bill succeeds in loosening the current credit crunch, most of us will benefit.”

23. From James Wilkinson: *“I have a financial advisor From UBS who lectures to my class on the Cornerstones of Investment. Should that be addressed at this point in the semester of Macroeconomics? Or after a lot more economic theory is given.”*

- **Answered during chat.**

24. From Michelle Proksa: *“What historical examples of US government regulation might be useful for discussing this financial crisis?”*

- **Guest Speakers Response:** “We went through something like this before during the Great Depression. It might be useful to discuss the decisions of the Federal Reserve during that time, particularly the decisions – starting with the Bank of United States in 1930 – not to provide loans to banks that the Fed considered to be insolvent or whose balance sheets included what the Fed considered to be too many risky loans or securities. The result of those decisions was a virtual collapse of the banking system by 1933. The reasons why Congress established the SEC and FDIC during 1933 and 1934 would also make for interesting class discussion because of the parallels to the current situation.”

25. From Warren Matthews: *“Some politicians have taken this crisis as an opportunity to condemn capitalism and argue for more state controlled markets or socialism.....what would you say to them?”*

- **Guest Speakers Response:** “Not sure there are too many politicians in the U.S. going so far as to call for socialism. There is no doubt, however, that we are in for a big political debate over the extent to which regulation of the financial system needs to be expanded. History has shown that there is tendency to overreact to a crisis with regulations that go beyond needed changes and unnecessarily reduce efficiency. A significant part of the strong growth performance of the U.S. economy during the last 20 years is attributable to the efficiency with which the U.S. financial system allocates capital. We should think long and hard before we take steps that would significantly reduce that efficiency. That said, we need to think about increasing capital requirements for non-bank financial institutions and linking those requirements to the degree of risk in the institutions’ investments.”

26. From David Allardice: *“Would you have allowed Lehmann to fail - given what we know today?”*

- **Guest Speakers Response:** “The Fed and the Treasury have been walking a tightrope as they try to shore up the financial system by helping distressed institutions without allowing moral hazard to get out of hand. Given how the situation has evolved since Lehman was allowed to fail, with hindsight, Bernanke and Paulson may want a mulligan on that one.”

27. From Athena Miklos: *“Do you think that this international financial crisis brings us to a much needed broader focus for macro economics that can no longer ignore the global impact on domestic economic issues and that text books should be rewritten to better illustrate this interdependency?”*

- **Guest Speakers Response:** “You are quite right that financial interdependency has been highlighted during this episode. Some texts already do a better job than others in highlighting this interdependency (modesty forbids our being more specific!). As we mentioned in the chat, teaching and writing about the principles of economics requires some flexibility. Beyond some core ideas that we need to cover every semester, the applications and the details of the institutions and laws that we discuss during a particular period depend very much on what is happening in the economy. Looking back to the beginning of modern principles textbooks, Paul Samuelson’s text, which first appeared in the late 1940s, distinguished itself from existing texts by focusing on the key macroeconomic issues that had not been adequately discussed in those other texts. Certainly, the financial crisis will have an impact on the topics that textbook authors highlight and those principles instructors cover.”

28. From Gita Srinivasan: *“Why is the federal reserve policy failing?”*

- **Guest Speakers Response:** “As discussed in some of the earlier answers, at this point, the Fed has not yet been able to restore confidence and – in conjunction with the Treasury – has not taken actions that will rebuild bank capital.”

29. From James Morse: *“Beyond the issues of this crisis is a recession. How would you approach teaching students about how to understand this event?”*

- **Guest Speakers Response:** “The ramifications of this episode fit within the usual macro principles story: High interest rates and the reduced availability of credit reduce investment spending and spending on consumer durables, leading to reduced aggregate demand and lower real GDP.”

30. From Heather Harris: *“... I felt that this situation today could have been predicted 3 years ago when we watched the price of gas skyrocket. People were clearly overleveraged on average then (buying homes and cars well beyond their means) and when a product with very inelastic demand almost triples something has to give. I'm not surprised by this situation today yet the government seems to be. Would government intervention on gas price escalation a few years ago have helped avoid the situation today or did the market just need to go into shock and level out regardless?”*

- **Guest Speakers Response:** “Rising oil prices certainly haven’t helped the macro situation, but it appeared that higher oil prices were going to lead to only a growth slowdown, or, at worst, a mild recession, until the financial system began to unravel. Rising oil prices do not appear to have been directly involved in bringing on the financial crisis. It’s also true that the economy is less vulnerable to rising oil prices today than it was during the 1970s. It’s not clear what short-term policies the government could have enacted that would have contained the increase in oil prices, other than price controls, which would have caused more harm than good.”

31. From Shannon Delaney: *“I am looking to buy a car, is that a bad choice?”*

- **Guest Speakers Response:** “There seem to be some great deals out there as the manufacturers are providing incentives and local dealers want to move cars off their lots to avoid having to finance them.”

32. From Heather Harris: *“What caused banks in the first place to change their conservative stance and decide to take on so much risky like the risky mortgage backed securities?”*

- **Guest Speakers Response:** “The “\$64,000 Question” as we used to say. With hindsight, it is clear that there was a lot of mispricing of risk. Securities that seemed to have moderate or low risk – a view ratified by the rating agencies – turned out to be very high risk. A longer term trend is that as banks have become a less important source of financing to businesses they have turned to other investments that have been inherently riskier.”

33. From Carrie Perkins: *“Do you think it would be a bad idea to buy a house right now?”*

- **Guest Speakers Response:** “Assuming you can obtain financing – that is, that you have at least a 20 percent down payment and an excellent credit score – you may well be able to find some bargains in the housing market. Market timing in the housing market – as in the stock market – can be hazardous because predicting when the bottom has been reached is very difficult. So, anyone who finds a house they like and can afford should probably buy now rather than wait for housing prices to fall further. That said, the returns to housing as an investment are typically quite low over the long run, so the decision to rent or buy should not hinge on the expectation of receiving a high investment return from buying.”

34. From Sy Sarkarat: *“What role increased on oil and gasoline price had on these crisis?”*

- **Guest Speakers Response:** “See answer to question 30.”

35. From Sarah Jackson: *“Too big to fail” is a term we are hearing a lot. Going forward, do you think anything needs to be done to prevent financial institutions from becoming too big to fail?”*

- **Guest Speakers Response:** “One of the things we have learned is that there are large economies of scale in providing financial services. So, regulations that artificially restrict the size of financial institutions – such as the regulations that used to restrict interstate banking, or, in some states, even restricted branch banking – impose a significant efficiency loss that is borne by depositors and borrowers. The key problem seems to be not size as such, but insufficient capital relative to the riskiness of assets. New capital requirements, rather than new restrictions on size, may be a better policy response to recent events.”