The Credit Crisis, Obama, and Change

Raghuram Rajan

Chicago Booth School of Business
Origins of Crisis: Bad Investments

- Child of past crises
  - Emerging markets => Industrial country corporations => Industrial country household

Emerging and Developing Country Current Account
Why the U.S.?

- Sophisticated U.S. Financial Sector
  - Matched mortgage borrowers from Arizona with lenders from Stuttgart.

- But risk stayed within the financial system.
  - “Earthquake insurance”
  - AIG and European banks
  - Where were the risk managers?
Origins: Financed with short term debt

- Short term debt cheaper because
  - Rolling over financing is easy in good times.
  - Lenders better protected.
  - Market requires banks to hold little capital because losses remote.

- Aided and abetted by low policy rates.
The Impact: Credit markets freeze

- Banks unwilling to substitute for shadow financial system
  - Worries about borrower credit risk.
  - Worries about own liquidity if lenders want money back.
  - Worries about likely fire sales pushing securities prices further down.

- Banks frozen: Problem of credit will get worse and will hamper recovery.
Macroeconomic response

- Typically monetary policy is the right tool – but policy has lost traction
  - Interest sensitive sectors impaired
  - Credit contraction shrinking investment and durable goods purchase
  - Inventory cut backs

- Household consumption has slowed dramatically, savings up
  - Wealth effects
  - Labor market
  - Credit
Consumption in the United States

Source: JP Morgan
Europe

- Western European collapse: External demand (Germany, Italy), housing (Spain, UK), and financial sector

- Difficulty in developing a common response
  - Leakage

- Bank-based system in continental Europe exacerbates problems
  - Exposure to Eastern Europe
Claims on Emerging Markets by BIS Reporting Banks, September 2008
(In percent of Creditor GDP)

Source: IMF
Japan

- Japan: Collapse in exports, investment, and consumption
  - Japanese financial sector not as badly hit
  - But collapse in external demand is weakening borrowers.
  - Corporate profitability falling because of reluctance to fire permanent workers
    - As workers are laid off, consumption will contract further

- May see rebound soon, but need world to grow for sustainable growth
Where will demand come from? Largely the U.S.!

Why will the U.S. be the residual demander of last resort?

- Less social insurance – less public tolerance for unemployment
- More willingness of the world to fund the US in times of trouble
  – Dollar stayed strong
Four Tasks for the US in the short term

- The Fed has to substitute for the credit that has evaporated from the shadow banking system by using its own balance sheet.

- The administration has to clean up the financial sector
  - Remove toxic assets off bank balance sheets
  - Get weak banks to recapitalize

- Stabilize the housing sector

- An effective fiscal stimulus
House Price Misalignments

United Kingdom
United States
Japan
Canada

1997 99 2001 03 05 07 08 Q3
Recoveries

- Fiscal policy contractions
- Monetary policy tightening
- Oil shocks
- External demand shocks
- Financial crises
- "Big Five" financial crises

Output gain after four quarters (percent from trough)
Time until recovery to previous peak (quarters)

Source: IMF staff calculations.
Possible scenarios

- **V shaped**
  - Inventory adjustment comes to an end
  - Stimulus kicks in
  - Central bank and bond markets substitute for bank credit and banks cleaned up.
  - Confidence returns and positive feedback loops emerge – stock market to consumption
  - Policies need to be appropriate and well-executed – financial sector key

- **U shaped**
  - Households continue increasing savings
  - Financial sector is not cleaned up quickly
  - Too many bailouts and political conflict
  - Unemployment goes to 10-12%.

- **L shaped (The D word)**
  - Political paralysis
  - Protectionism
  - Societal conflict, perhaps war
President Obama’s Policy Agenda

- Leveling down
  - Regulation
  - Taxation
  - Unionization

- Expanding opportunity
  - Education
  - Healthcare
Public Debt

- Advanced economies
- World
- Emerging and developing economies

Source: WEO database projections.
THANK YOU