Notes on the Twin-Crises of 2008: From Gloom to Hope

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The current financial crisis had its origins in the real estate and subprime mortgage markets toward the end of 2006. Since then, it has spread through the entire financial system and the global economy. While the crisis was built in steps, it took a dramatic turn for the worse during the third quarter of 2008, after the Lehman-AIG events. In fact, it is useful to split the current recession into two related but distinct types of recessions.

Recession I was a more or less standard credit crunch/real estate recession. There have been many of this kind of recessions in the developed world during the last 30 years; on average they add half of an extra quarter of duration to the more plain-vanilla recessions (from 3.5 to 4 quarters) and one percent more of cumulative output loss (from 2.5 to 3.5 percent of output). Having started Recession I at the end of 2007, its normal inertial forces had already weakened it by the third quarter of 2008, and the elements for a recovery were beginning to emerge.

But Recession II, triggered by the Lehman-AIG event, interrupted all of this. This is a different kind of recession. It is the result of the collapse of nearly all forms of (explicit or implicit) private insurance contracts. An economy with no insurance contracts operates very differently from the standard modern economies we are accustomed to in the developed world: There is limited uncollateralized or long term credit, the risk premium sky-rocks, economic agents hoard massive amount of resources for self-insurance and real investment purposes, etc. During the last quarter of 2008 we have witnessed the beginning of a transition from an economy with insurance to one without it. If we do not stop this process, the outlook will be much worse than the common forecast.

It is easy to understand why financially constrained agents cannot go about their businesses with the flexibility they once enjoyed. This is what dominated actions during Recession I. However, the real hope for a recovery, as well as the concern for a meltdown, lies on the other side of the spectrum, on the unconstrained agents. This is what has failed in Recession II. At this juncture of the crisis there are mountains of investment-ready cash waiting for some indication that the time to enter the market has arrived. But investors are frozen, staring at each other, and by so doing, they are dragging the economy downward even further. The normal speculative forces that trigger a recovery are that everyone wants to arrive first, to “make a killing.” But with so much fear around us, investors have changed the paradigm and they are contempt with arriving second, so we are stuck.

Other cash-rich investors see great investment opportunities in the not so distant future, but in the meantime, they do not unlock their resources for fear that the temporary investments may turn illiquid, a process which in itself contributes to widespread illiquidity; or because the lack of competition brought about by a crisis almost ensures a better deal in the future.

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Still others go one step further: By profiting from illiquidity and panic itself by shorting run-prone financial institutions they close the circle of fear that fuels the runs.

We need to wind back this mechanism by restoring the appetite for arriving first. This, however, is difficult to do in an environment where most of the effort goes into crafting stories of gloom. I do not mean to say that this recession is an imaginary one. On the contrary, I believe it is a very serious recession. My point is simply that good policy has an opportunity to bring the recession back to familiar turf by defeating the extra gloom, and if this happens, the recessions will become a manageable one from which current asset prices, on average, will look like once-in-a-lifetime deals.

I build my analysis on three premises and observations: First, before the crisis we lived in a world with excess demand for assets, especially AAA assets, and this will not change significantly once the crisis has ended. Second, contrary to what investors thought at the peak of the boom, the (private) financial sector in the U.S. is not able to satisfy this demand for AAA assets when large negative aggregate events take place. However, we also have learned that the U.S. government does have the capacity to fill this gap, especially because it is the recipient of flight-to-quality capital. Third (and with the benefit of hindsight), the main policy mistakes were made during rather than before the crisis.

These observations hint at the correct policy framework after and during the crisis. For the former, we can go back to a world not too different from the one we had before the crisis (real estate prices and construction sectors aside), as long as the government becomes the explicit “monoline of extreme aggregate risk.” That is, while monolines and other financial institutions can lever their capital for the purpose of insuring microeconomic risk and moderate aggregate shocks, they cannot be the ones absorbing extreme aggregate shocks. This must be acknowledged in advance, and paid for by the insured institutions.

This conclusion about the long run policy spills over to the crisis-policy itself, as the essence of a solid recovery comes not from deleveraging and an excessive forced contraction of the financial sector, but from the explicit and massive insurance provision against further negative aggregate shocks to their balance sheets caused by panic. The recent intervention to Citi, with a mixture of (paid) insurance and capital, is very promising, and so is the second intervention to AIG. They now need to be scaled up to the whole financial system, and it is better to do it all at once, for in this case the likelihood of the government ever having to disburse funds for its insurance provision becomes negligible.

Essentially, the U.S. financial markets are experiencing the modern version of a systemic run as had not been seen in the U.S. since the Great Depression. It used to be that depositors run from banks. Some of this still happens, but runs in modern financial markets, to be systemic, have to involve a larger class of assets. A run against explicit and implicit insurance is essentially a run against virtually all private sector financial transactions but for the shortest maturities. Thus, the modern lender-of-last resort facility has to be a provider of broad insurance, not just deposit insurance. This is what it will take to get us back into a reasonable equilibrium where we can initiate a recovery from a (more) “normal” recession.