Comments on “The Great Escape”

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Nonstandard open market operations: “the government exchanges highly liquid liabilities for less liquid private assets”

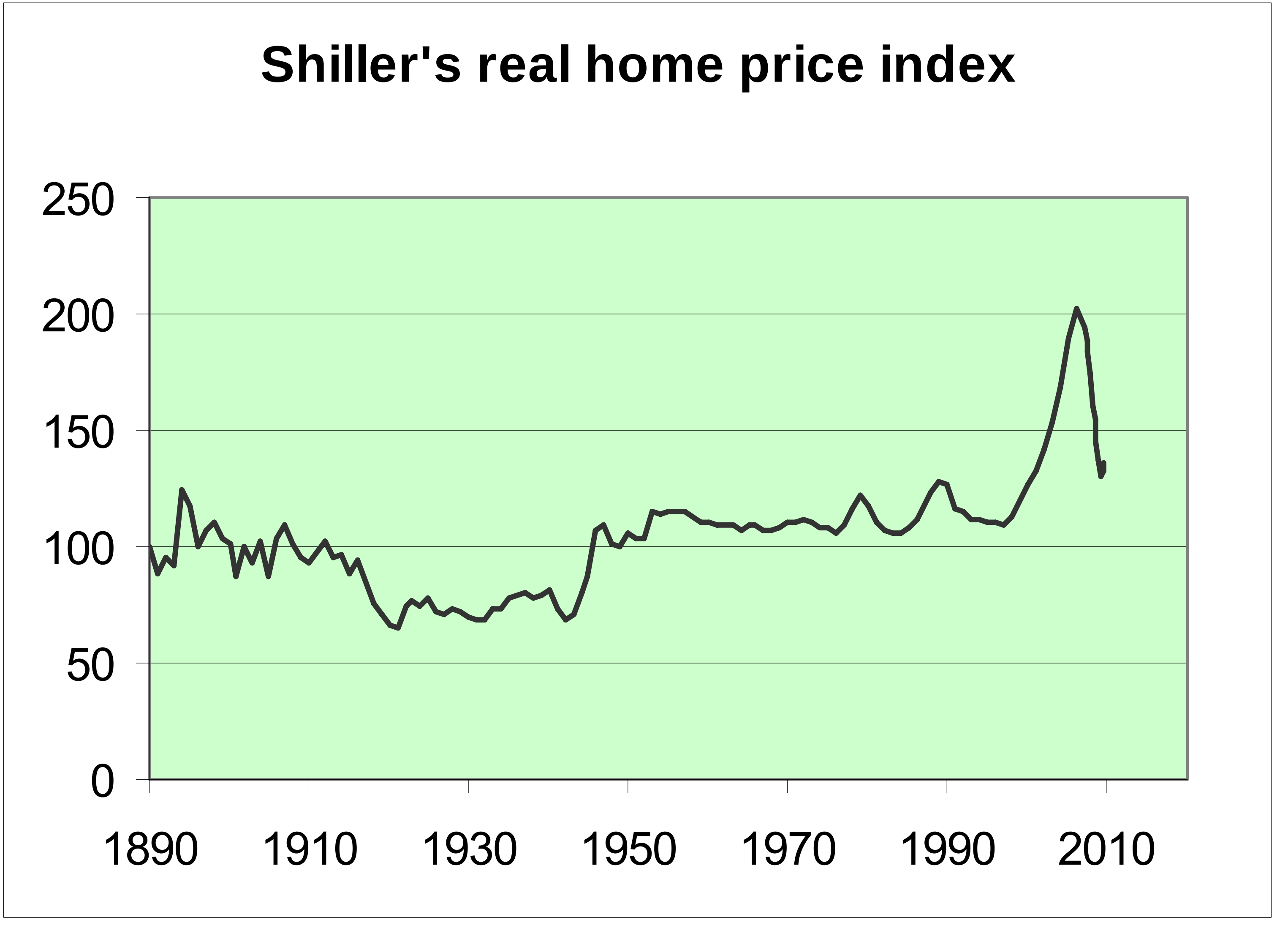
Examples: use deficit finance or debt guarantees to subsidize

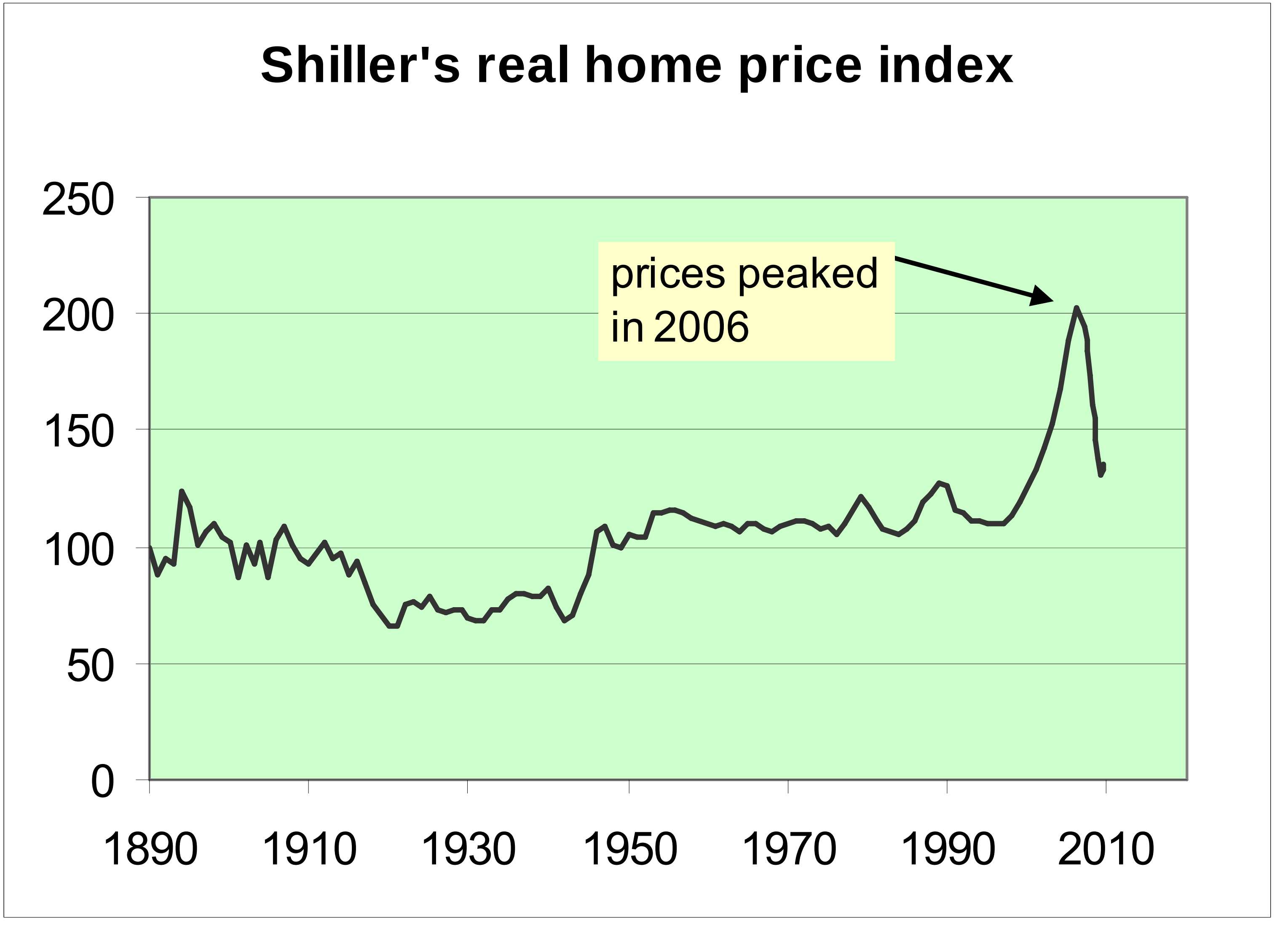
- mortgages
- student loans
- DOE loan guarantees

Also called standard fiscal operations

Other examples:

- de facto nationalization of liabilities of Fannie Mae and Freddie Mac (over $5 trillion notional)
- broad extension of FDIC guarantees (another $5 trillion)


Shiller's real home price index
250
200
150
100
50
0
1890
1910
1930
1950
1970
1990
2010



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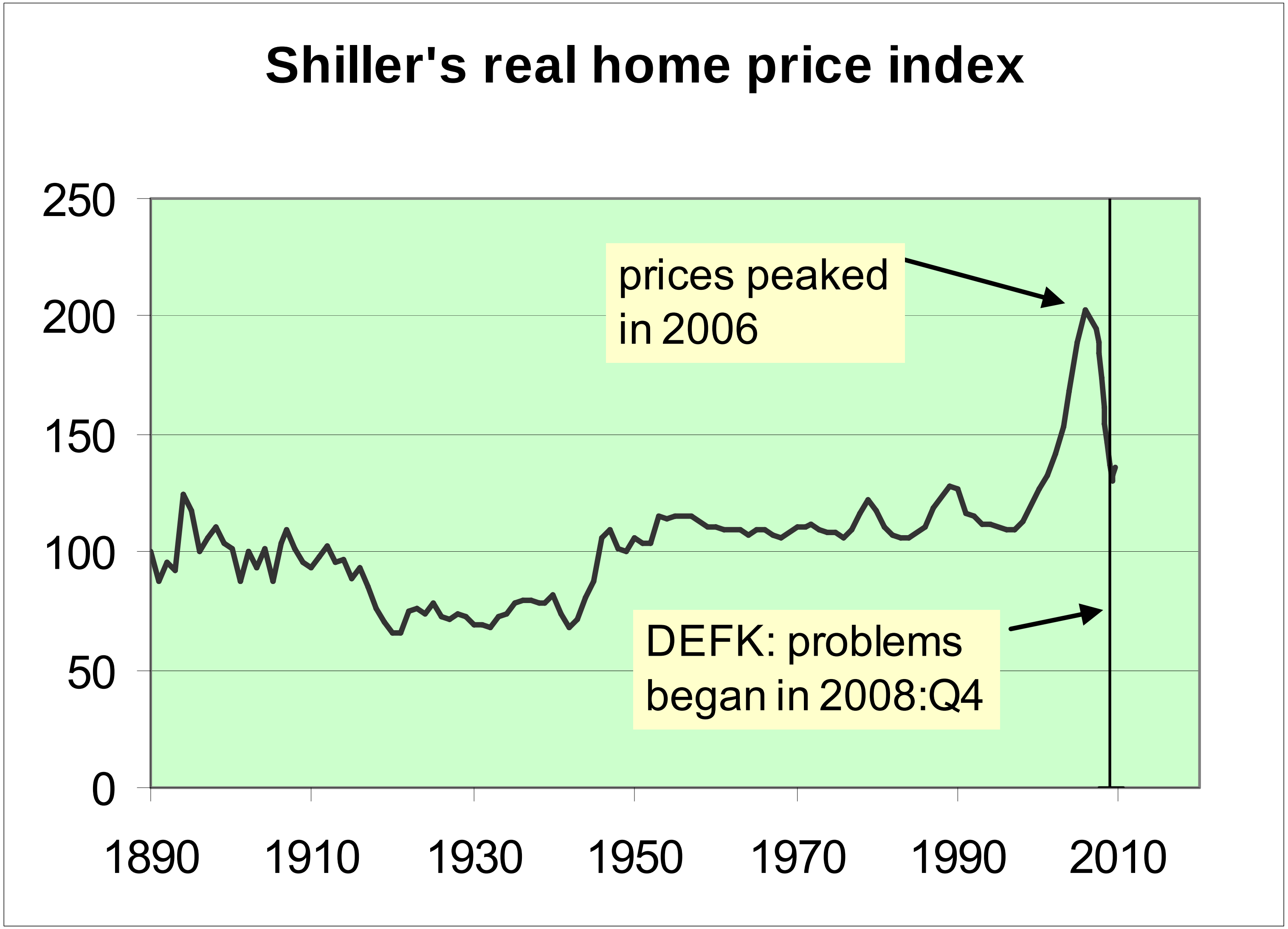
prices peaked
in 2006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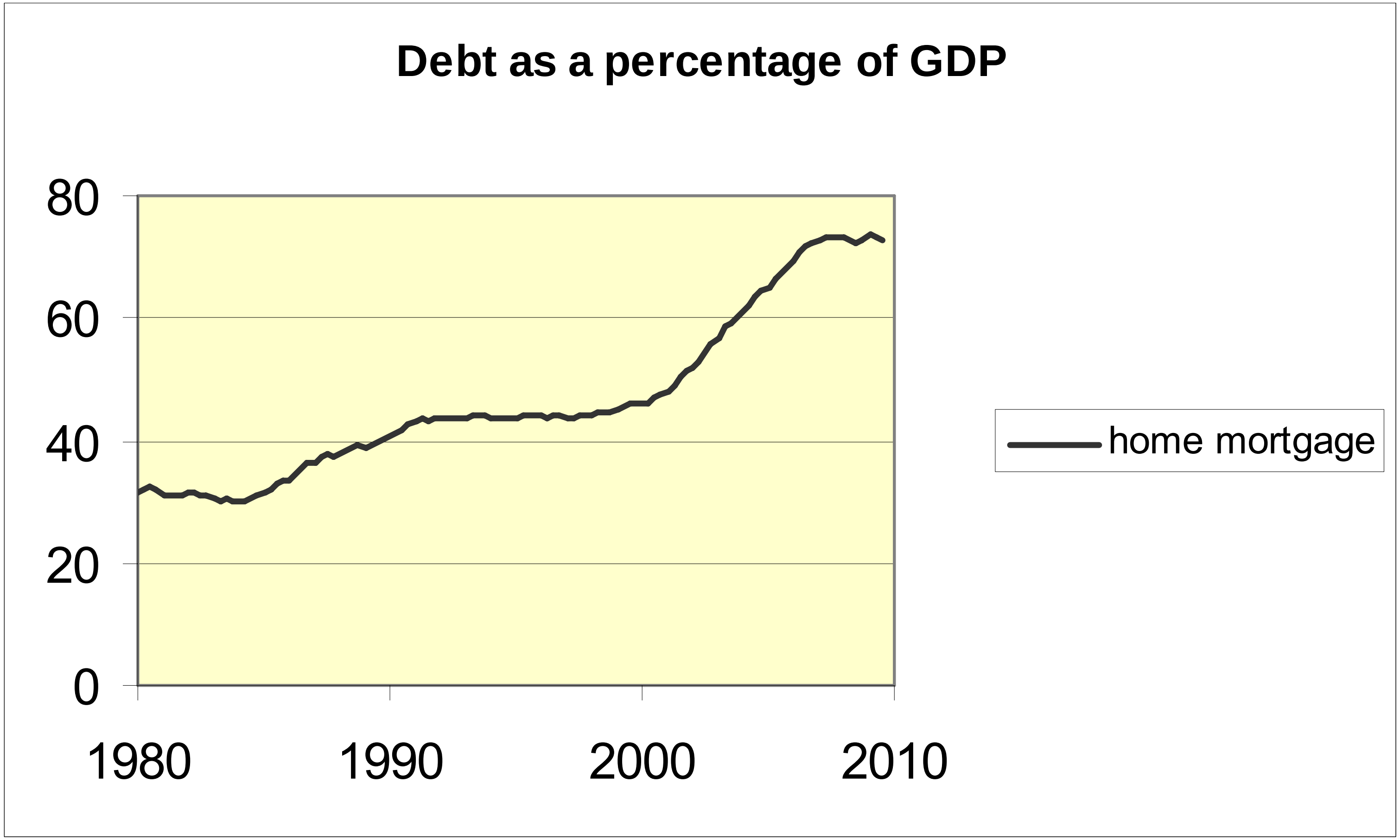
prices peaked in 2006
DEFK: problems began in 2008:Q4

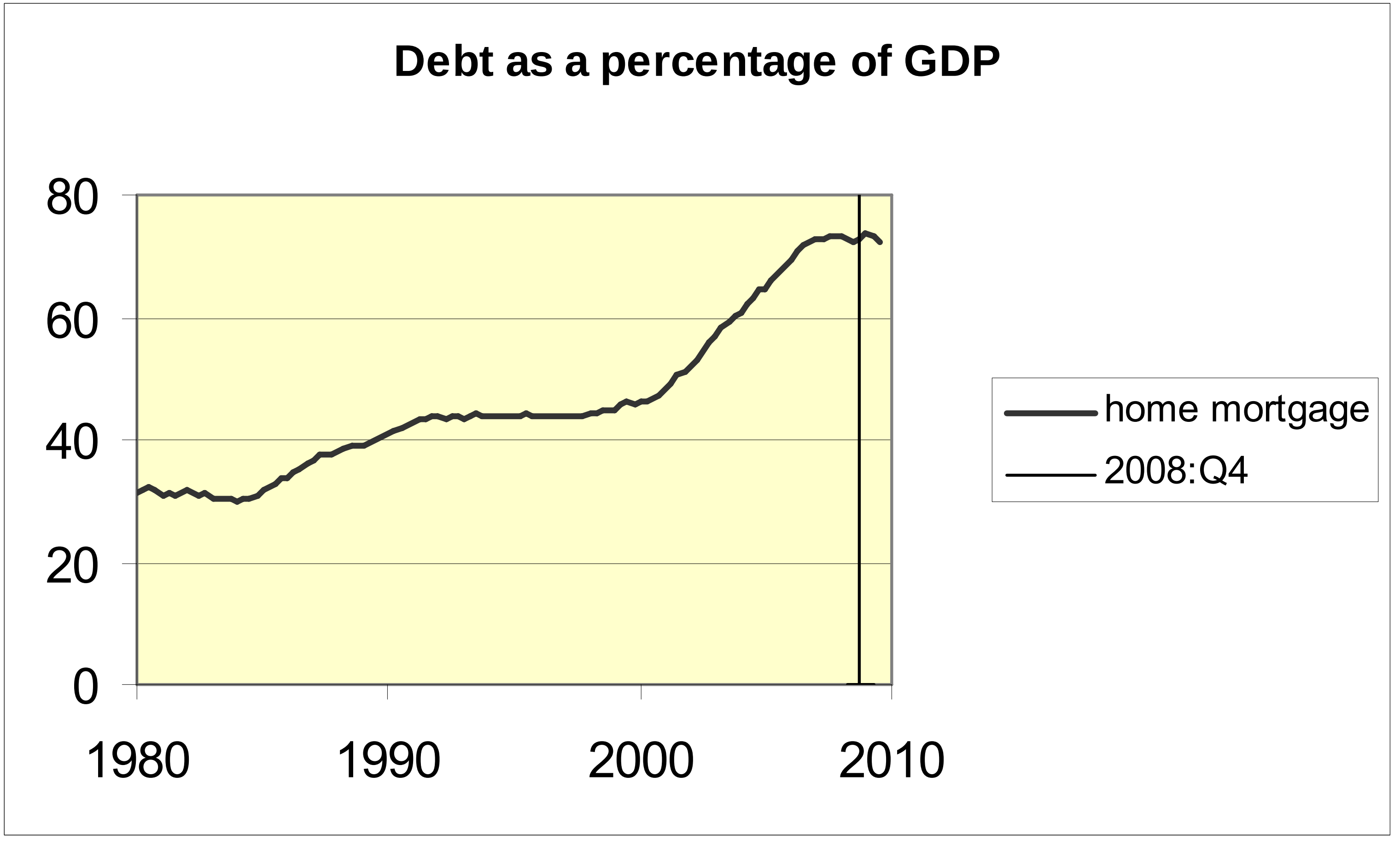
Benefits to endogenous account of financial crisis:

(1) Do we want to know how to respond or how to prevent?

(2) Evaluation of central bank: were low interest rates and lax regulation 2004-2006 part of the problem?

(3) Research agenda: model credit frictions or explain anomalies of 2004-2006?


Debt as a percentage of GDP
80
60
40
20
0
1980
1990
2000
2010
home mortgage



Debt as a percentage of GDP
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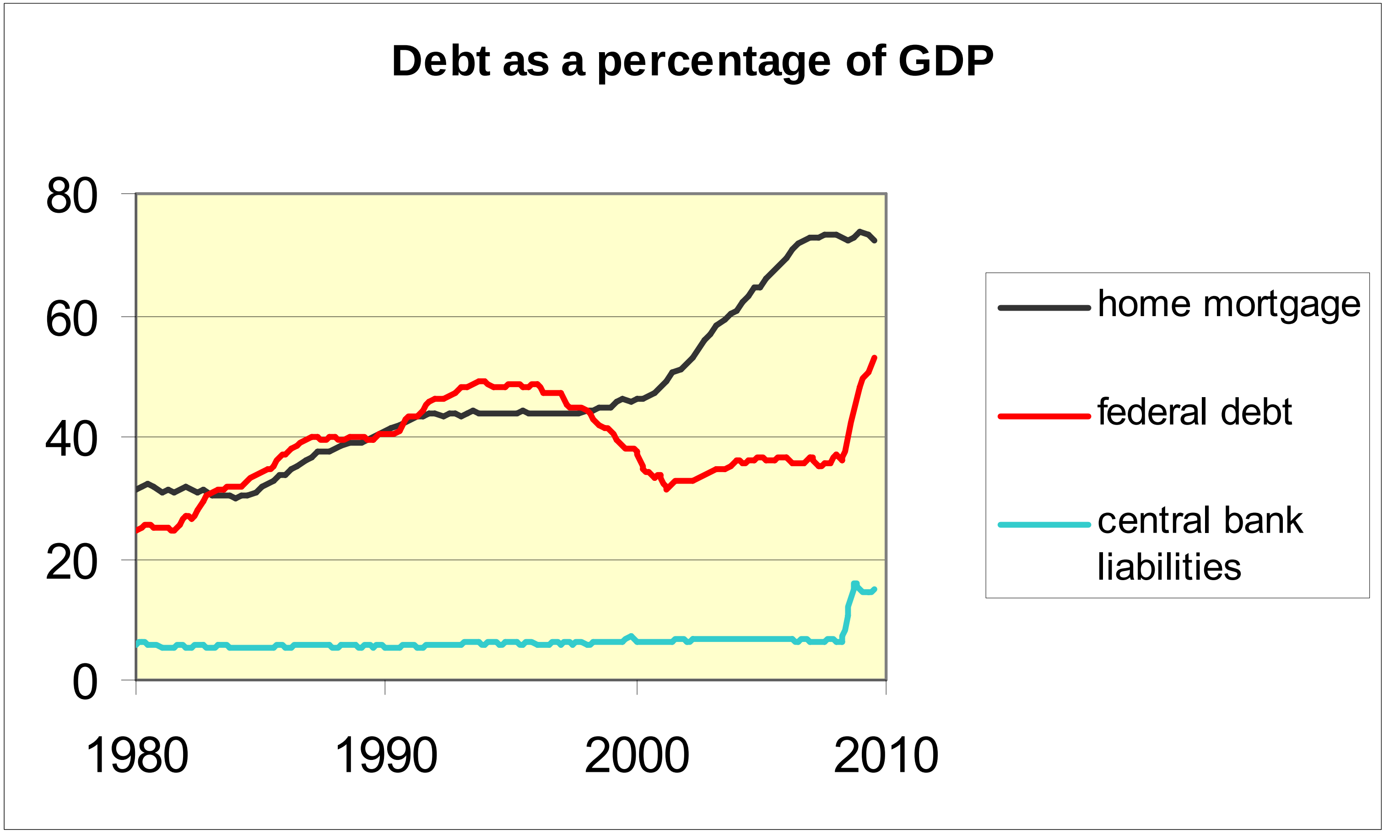
home mortgage
2008:Q4



Debt as a percentage of GDP
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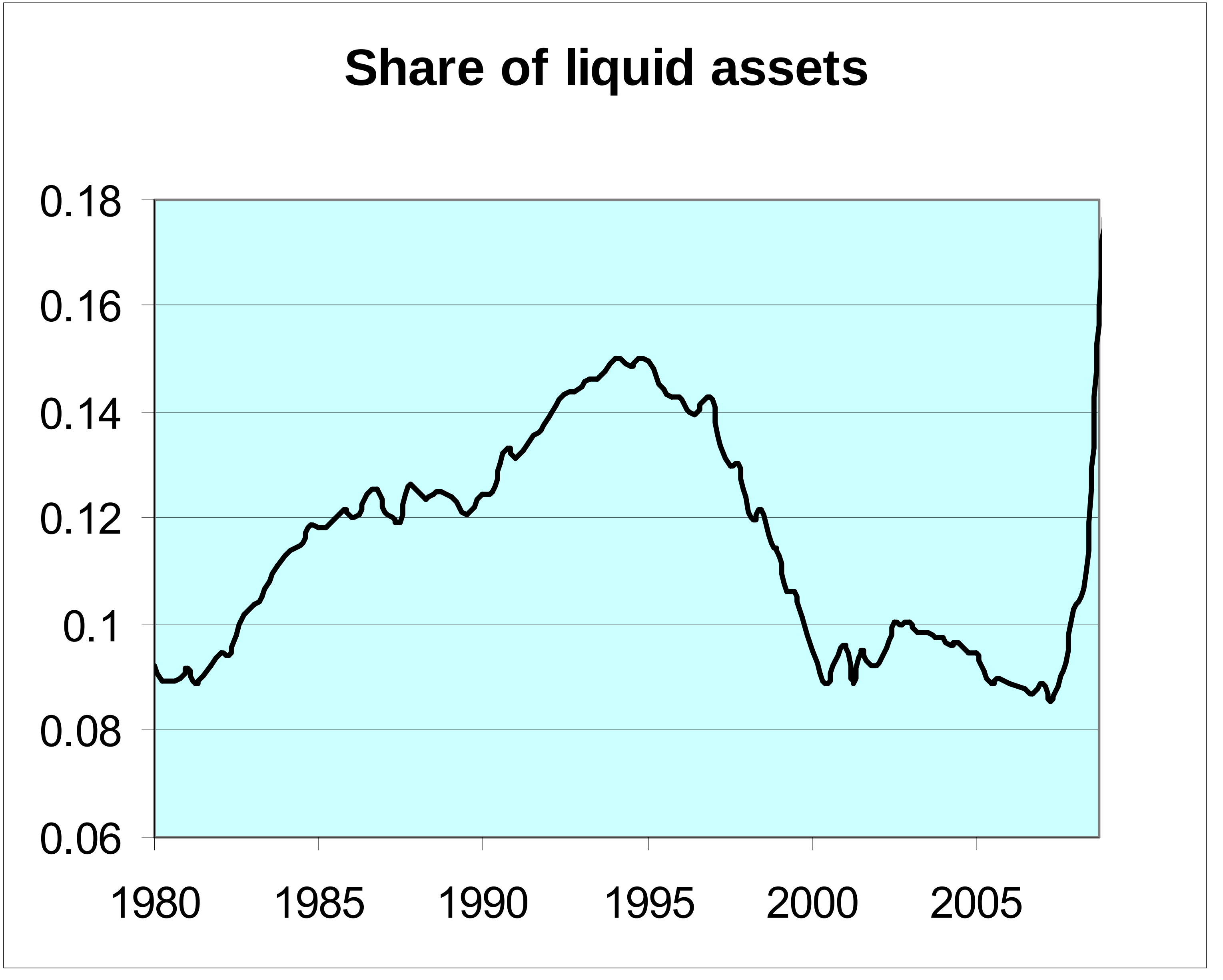
home mortgage
federal debt
central bank liabilities

Model: to finance investment entrepeneurs can either

- self finance (with liquid assets)
- external finance (issue new or sell existing equity)

Financial crisis: exogenous decrease in φ_t (fraction of equity I can sell)

Model implies that in response to such a shock, liquid assets as a fraction of total assets would rise



Share of liquid assets
0.18
0.16
0.14
0.12
0.1
0.08
0.06
1980
1985
1990
1995
2000
2005

Factors that account for the 2008:Q4 increase in liquid asset share in the data:

- 31% from increase in deposits with Federal Reserve
- 27% from increase in credit market instruments of U.S. Treasury
- 20% from decrease in market value of outstanding equities

Could interpret these in narrow mechanical terms or as broad indications of shift in φ_t

Are DEFK claiming that even if the Fed and Treasury had not responded, this series would still have spiked up similarly through an even bigger drop in equity prices?

Nice to supplement with case study corroboration: what are exact frictions, and what is independent evidence of their operation?