ECO 313, Fall 2017, Homework Assignment #6
Due by Friday, April 8

This is an optional homework assignment. Students who complete it satisfactorily will have their lowest homework score dropped and replaced with full credit.

1. Read the following 15 midterm questions and abstracts.

For #2-5, you may not select the same question/answer more than once. Nor may you select your own question/answer.

2. Briefly (one or two concise paragraphs) discuss a question/answer that illustrates a policy that contributed top the Great Recession in a way that should have been foreseeable.

3. Briefly (one or two concise paragraphs) discuss a question/answer that shows a contributing factor to the Great Recession, but which was not a forseeable result of policy.

4. Which question/answer do you find to be the most informative?

5. Which answer are you most skeptical of?

Question #1: Despite neither being a true financial firm, both Chrysler and General Motors were bailed out as part of the TARP program. Suppose that the Federal government had allowed both firms to fail. What would have been the likely economic impact and would there have been any benefits to taking this course of action.

Abstract: General Motors (GM) and Chrysler LLC, two of the Big Three automobile manufacturers in the United States, were two of the non-financial firms that the Federal Reserve bailed out during the Global Financial Crisis. After heavy losses and failure to restructure in the time leading up to the Crisis, GM and Chrysler found themselves in financial danger. These once prominent automotive producers approached congress multiple times for lending aimed towards technological improvement and TARP funds to assist with operating costs. Even with aid, GM and Chrysler filed for bankruptcy. This paper details the approach to aid and reorganization of both of these institutions, which allowed them to fully pay off their debts sooner than expected. Furthermore, this paper argues that the bailout of GM and Chrysler was important for the United States' economy, as this not only saved the United States auto industry but the jobs that connected to it.

Question #2: Discuss why the government decided to bailout AIG and whether or not it was the right decision to do so?

Abstract: During the 2008 recession many large financial institutions were on the verge of failing. One of these firms was insurance giant AIG. The firm received a government bailout that totaled to 185 billion dollars. The reason the government decided to bail AIG out was that their distress was coming from only one of their businesses, the financial products group. The group started selling derivatives knows as credit default swaps which were essentially insurance on residential mortgage backed securities. The increased demand for these swaps resulted in a substantial increase in the revenue of the financial products group. When residential mortgage backed securities started to fail at exorbitant rates AIG was unable to the money they owed to investors. AIG was also a holder of many MBSs which meant they hadnt hedged their investment on CDSs at all. The bailout was necessary because AIG was too big to fail. They were so integrated into the financial system that their collapse would have effected holders of the credit default swaps they issued, their conventional insurance policy holders, and many peoples retirement savings.

Question #3: The Trouble Asset Relief Program was among the most signicant policy responses to the Great Recession. What is the state of expert opinion on the programs effectiveness and what is your own opinion?

Abstract: This paper evaluates the state of expert opinion regarding the effectiveness of the Troubled Asset Relief Program (TARP), and ultimately offers its own conclusion. It finds there is no clear consensus among experts. Taylor (2011) and Stiglitz (2011) share a pessimistic view of the policy, arguing that the rollout of the program created more problems and legacy costs. Moreover, Montgomery et al. (2014) found TARP did not stimulate loan growth but allowed banks to restructure their balance sheets. Lastly, Roman et al. (2017) and Huerta et al. (2011) found TARP had a stabilizing effect on financial markets. From these expert opinions, the paper opines that TARP was effective for the reasons Montgomery et al. (2014), Roman et al. (2017) and Huerta et al. (2011) found, despite its poor rollout. However, it is unclear if the programs legacy costs will materialize.

Question #4: The Trouble Asset Relief Program was among the most signicant policy responses to the Great Recession. What is the state of expert opinion on the program's effectiveness and what is your own opinion?

Abstract: The Fed says it could not have bailed Lehman Brothers put legally because it would have been illegal. Those assigned to Lehman Brothers' financials never got a chance to make the Fed aware of their findings. The decision to let Lehman fail was a political decision by Hank Paulson, the Secretary of the Treasury, who did not want to be known as Mr. Bailout. Instead, he is known for letting a housing bubble cause a financial crisis and severe recession. He changed his mind quickly

and let the Fed bail out AIG a week later. The arguments for a bailout in hindsight were the credit market would not have dried up, and the world economy would not have felt the negative effects of the Lehman Shock. The arguments against the bailout were the idea of moral hazard and it was the push Congress needed to act quickly and powerfully.

Question #5: Commodities prices, especially oil, are often seen as a major contributor to macroeconomic fluctuations For example, the OPEC oil embargo of 1973 is viewed as a significant cause of the subsequent economic slump that followed. Analyze the role of commodities prices in Great Recession. Did they make the situation worse or better?

Abstract: To determine whether the deflation of prices in the commodity market worsened or improved economic conditions, a distinction must be made that between manufacturing-oriented and service-oriented economies. The role that the commodity market plays depends largely on this distinction due to the inherent differences in the economic structure of countries that fall into either category. For example, service-oriented economies are driven by intangible inputs (i.e. knowledge and skills), while manufacturing-oriented economies rely more heavily on tangible resources as inputs (i.e. raw resource). While lower commodity prices are detrimental to the manufacturing-oriented economies, for service-oriented economies, lower commodity prices results in more money in the pocket of consumer, leading to greater consumption that boost overall demand. Thus, the deflation of commodity prices at the onset of the Great Recession provided the necessary stimulus to help facilitate in the ultimate recovery of the economy.

Question #6: Mortgage default can be divided into strategic default-cases where the borrower has the ability to pay but chooses not to- and non-strategic-cases where they have no realistic ability to make their payments. How widespread was strategic default during the initial (2007-2008) wave of widespread foreclosures?

Abstract: During the mid 2000s, a speculative bubble existed in the housing market subsequently creating the subprime mortgage crisis. For the first time arguably since the Great Depression, millions of American households found themselves with a mortgage that exceeded the value of their home. Given the extent of this phenomenon, homeowners with large negative equity values were faced with the harsh reality of walking away from their houses despite having the ability to afford their mortgage payments. This was an action known as strategic default and in 2007-2008 in particular, as housing prices began to dive, strategic defaults became extremely common for financial reasons. The most likely candidates to strategically default were individuals who came from a stable financial situation with above average credit scores, households who experienced large peak-to-trough drops in the state

they resided in, and homeowners whose morality affected their willingness to walk away and hence strategically default.

Question #7: The Securities and Exchange Commission requires that nancial institutions engage in mark to marketaccounting. This implies that assets must be valued at their sale price instead of,perhaps, their expected prot stream. As a result, nancial institutions may have to adjust their holdings in response to movements in asset prices (if, for example, they have to meet a capital requirement).

It has been suggested that mark to market accounting contributed to the nancial crisis. Research this issue and 1) provide a brief summary, and 2) provide your opinion as to what, if any, role this policy played in the nancial crisis and ensuing recession.

Abstract: Mark to market (M2M) accounting requires institutions to adjust the value of their assets based on their current market value. In the years preceding the Great Recession, mortgage backed securities (MBSs) had become ubiquitous. Following the bursting of the housing bubble mortgage default rates increased and with them the value of MBSs decreased substantially and rapidly up to the point where they were almost untradeable. This resulted in their market valuations being pennies on the dollar despite the fact that in the long term many MBSs were still performing well. Nevertheless, many major institutions holding MBSs suddenly found themselves needing to raise capital following the M2M in order to meet regulatory requirements. They then would sell MBSs at fire sale prices in order to meet these requirements thereby exacerbating the problem. M2M accounting has received varying degrees of blame for worsening the Recession and there are several possible policy responses.

Question #8:The GSEs remain in conservatorship where they have resided since 2008. Discuss potential ideas (either proposed by you or someone else) for removing them from conservatorship. Discuss how this plan might make a re-peat of the housing bubble more or less likely.

Abstract: Fannie Mae and Freddie Mac were headed down a dark path before they were taken in conservatorship. Since then, economists and politicians argued for different ways to change the current status of the two GSEs. Their balance sheet shows that they still are a major player in the secondary mortgage market and could have large ripples in the economy. Before 08 their odd ties to the government created bad incentives allowing for Fannie and Freddie to take huge risk with very little downside. One way to get this exposure off the taxpayers balance sheet is to completely privatize both of them. This paper explores the way the Treasury department would unwind them from conservatorship to being completely on their own. This paper posits that both companies would be able to still provide liquidity in the secondary mortgage market without posing a systemic threat to the economy.

Question #9: Since the aftermath of the Financial Crisis, the Fed has paid interest on excess reserves. Discuss the costs and benefits of this policy and argue why it was, or was not, a wise policy choice for the Fed to pursue.

Abstract: The Financial Services Regulatory Relief Act authorized the Fed to pay interest on excess reserves held by banks starting October 2011, which was eventually moved up October 2008. Previously, the Fed was tasked with keeping the excess reserves scarce in order to implement effective monetary policy; however, the increase in the Federal Reserves liquidity facilities and excess balances made it challenging for the Open Market Trading Desk to attain the target federal funds rate. The payment of interest on reserves would effectively help establish a lower bound on the federal funds rate and provide better control of reserves when the Fed started to move away from quantitative easing. This way, the Fed could obtain traditional objectives while also maintaining a role in the credit markets. This paper explores the advantages and disadvantages of this policy and whether or not it was an effective policy for the Fed to implement.

Question #10: The Federal Reserve was both faster to lower interest rates than the European Central Bank, and faster to use several non-conventional policies such as quantitative easing. Does this difference explain why the Great Recession was less severe in the United States compared to the Eurozone?

Abstract: The difference in timing for each respective central banks implementation of expansionary monetary policy serves to highlight the importance of selecting the correct fiscal policy. For the U.S., the Federal Reserves fast-to-act mentality allowed the necessary, expansionary monetary policy to be implemented, which when combined the U.S. governments implementation of a stimulative fiscal policy basically ensured a U.S. recovery from Global Financial Crisis. Unfortunately, this was not the case for Europe. Due to the European Central Banks slow-to-act mentality, it stalled the implementation of the necessary, expansionary monetary policy. In turn this would require a highly stimulative fiscal policy to make up for the European Central Banks slowness. However, instead of compensating for the tardiness of expansionary monetary policy with a highly stimulative fiscal policy, Europe decided to implement an austere fiscal policy which exacerbated the severity of the effects associated with the Global Financial Crisis.

Question #11: The price to rent ratio is often used as a measure of bubbles in the housing market. An alternate approach would be the ratio of prices to a measure of building costs? Is such a measure valid? And how has it behaved since 2000.

Abstract: After the global financial crisis, economists began to develop methods to track possible

bubbles in the housing market. A price to rent ratio has been recently utilized in predicting bubbles as a high ratio might suggest that house prices are too high and unrealistic, compared to lower renting prices. Price to building costs may also act as a predictor because of a similar concept: if prices increase while building costs do not, then it suggests that a house is overpriced. This ratio was analyzed using historical data since 2000. Graphs of the ratio show a spike in 2007, directly before the recession began. The recent trends in this data therefore do suggest that this ratio may be a measure for predicting bubbles in the housing market.

Question #12: Suppose that the U.S. had used a buyer pays model instead of an investor pays model for credit rating agencies through 2008. Would such a model have been viable, and might it have prevented or mitigated the nancial crisis?

Abstract: The credit ratings agencies played a major role in allowing the economy to spiral into the worst recession since the Great Depression. The model in which these credit rating agencies made money led them to be biased, which corrupted many asset ratings within the financial markets. The model the CRAs used was called an investor pays model, which is where the banks pay them to rate their assets. This results in biased ratings, as the rating agencies try to attract business from the banks in the form of generous ratings. An alternative to this model is the buyer pays model, which is when the credit ratings are available via paid subscription. In this paper I will go over what would have happened if these credit rating agencies had used a buyer pays model, instead of an investor pays model, and whether such a model could have prevented the financial crisis.

Question #13:When the FOMC lowered interest rates to near in late 2008, financial markets expected rates to remain so low for only a few months. What would have been the consequences if the FOMC had said that it expected rates to remain near zero for a longer period of time and should they have done so in retrospect?

Abstract: At the onset of the Great Recession, no one knew the extent to which the future of the economy would bring. In order to manage the damage, the FOMC immediately lowered interest rates that eventually brought them down to the zero bound level. It was the FOMCs expectation that this would alleviate pressure on markets and allow for a greater degree of spending in order to halt the pace of deleveraging. However, ambiguity surrounded the time frame as to how long these levels of low-interest rates would last. As a result,mid-long term bond yields did not fall as much the Fed hoped for. Later on after 2009, the Fed successfully launched its QE program which helped recover economic growth that was needed. If the Fed had done this sooner, the blows to productivity and unemployment wouldnt have been subdued, reducing the worse effects of the recession.

Question #14: Question: In loosening the capital rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves.

Abstract: The Financial Crisis of 2008 consisted of the fallout of several of the countrys largest banks. Many economists criticize the SECs loosening of capital rules in the years preceding the recession, explaining that these rules contributed to the banks large leverage ratios and thus their bankruptcies. However, the changes in the net capital rules never explicitly changed any regulations involving leverage ratios and the empirical evidence fails to support this standpoint. Instead, a less prominent theory highlights the SECs influence over the banks that may have influenced their investing decisions. Through their regulation requirements, the SEC supported the idea that mortgage backed securities were rather safe assets. This influence towards a concentration in mortgage backed securities may have contributed to the fallout following the mass defaults in the mortgage market.

Question #15: The United States is a relatively open economy with a flexible exchange rate. How did these factors impact the severity of the Great Recession (i.e. would have the recession have been worse had the U.S. had a fixed exchange rate?) How did these factors impact the ability of the Federal Reserve to respond to the crisis?

Abstract: By solving it I got familiarized further and my knowledge consolidated about the fixed and flexible exchange rate regimes. The gigantic role of the Central Bank can plays a vital role in the economy of any country, specially, Fed in case of United States, was elucidated to me through this topic. To answer the question, I had to dig out what the two regimes are about, which is better or worse, and how can fixed exchange regime be maintained by the central bank. I furthermore learned more about the nature of the recession as I looked closer at it with an analytical perspective, which is a very important event as well as lesson of our economic history.