The Notorious Summer of 2008

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Any opinions expressed here are mine and do not necessarily reflect those of others on the Federal Open Market Committeee.

Introduction

Fifth anniversary of a notorious event

- Five years ago the U.S. economy was suffering in the aftermath of a substantial financial panic.
- This talk addresses some of the features of the macroeconomic situation in 2008.
- These events are likely to be studied for decades to come.
- The features I outline here today have to be addressed in any comprehensive accounting of what happened.

Start date

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- Some revisionist historians link the beginning of the financial crisis to the collapse of Lehman and AIG in September 2008.
- However, the financial crisis had been underway for more than a year at that point.
- One conventional dating for the beginning of the crisis is August 2007.
- The case for this date can be clearly seen in the data concerning the Libor-OIS spread.*

*For more detail, see R. Sengupta and Y.M. Tam, "The LIBOR-OIS Spread as a Summary Indicator," Federal Reserve Bank of St. Louis *Economic Synopsis*, 2008, No. 25.

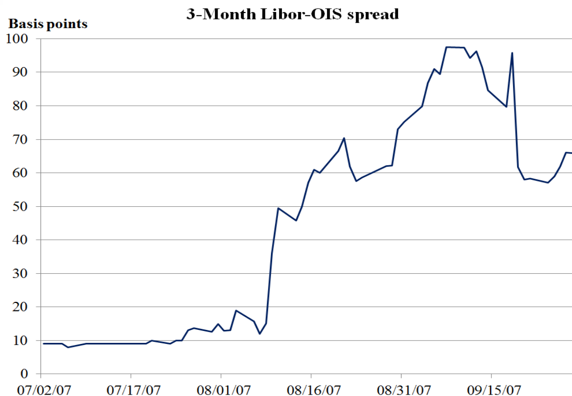

FIGURE: The Libor-OIS spread began rising substantially August 9-10, 2007, an indication the financial crisis had begun in earnest.

IMPLICATIONS AS OF AUGUST 2008

- The fact that the crisis had been continuing for a year without turmoil in financial markets suggested more financial stability than actually existed in the system.
- There were no clear signs that many financial firms were about to fail catastrophically—only limited examples during the first year of the crisis, August 2007-August 2008.
  - My view was that financial markets were no longer surprised by a crisis that had been continuing for an entire year.
- There was a reasonable case that the U.S. could continue to "muddle through" the crisis so long as real GDP growth remained positive.

What happened?

- My argument is that the economy slowed substantially during the summer of 2008, greatly exacerbating the financial crisis and leading many financial firms to fail.
- This slowing of the economy, however, was not readily apparent during the summer of 2008.

Lower interest rates

FED EASING

- The FOMC recognized the crisis in August 2007 and reacted using conventional tools.
- The FOMC lowered the federal funds rate target substantially in the September 2007-March 2008 time frame.
- This was often cited during the first half of 2008 as likely to help the economy considerably during the remainder of the year.
- As events unfolded, any positive effects from lower interest rates were totally swamped by the effects of the panic.
- This suggests that the rate reductions were essentially impotent in the face of the storm to come later in the year.

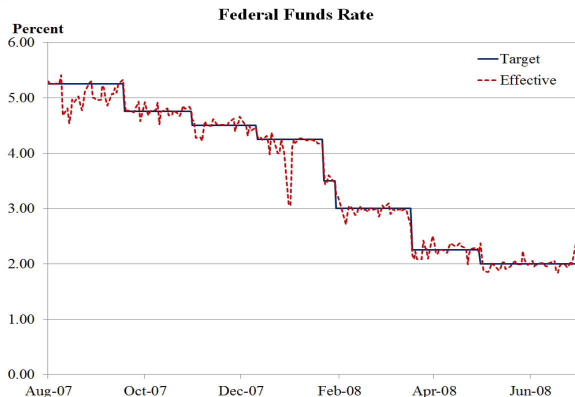

FIGURE: The FOMC lowered the policy rate target steadily during the first 9 months of the crisis.

Interpretation of Fed easing

- The cut in the policy rate during the September 2007-March 2008 time frame was not as good a tonic for the situation as might have been hoped.
- Within the Fed, the idea that "lower interest rates cure all" is commonplace.
  - Surely, temporarily faster growth associated with lower rates would be valuable in mitigating the crisis?
- But the rate cuts of early 2008 evidently did little to prevent the financial panic, and may have exacerbated the situation to some degree ... a point to which I will now turn.

Oil price shock

Commodity price boom

- Anecdotal reports during the first year of the crisis suggested that financial firms whose MBS-based portfolios were souring were desperate to earn substantial revenues elsewhere.*
- The "elsewhere" may have been global commodity markets, which boomed during the second half of 2007 and the first half of 2008.
- The lower interest rates the Fed engineered seemingly encouraged this activity, as firms borrowed cheaply and attempted to profit in commodities.
- The most macroeconomically significant commodity, oil, reached $145 a barrel during July 2008.

*See P. Basu and W.T. Gavin, "What Explains the Growth in Commodity Dervatives?" Federal Reserve Bank of St. Louis *Review*, Jan./Feb. 2011, pp. 37-48.

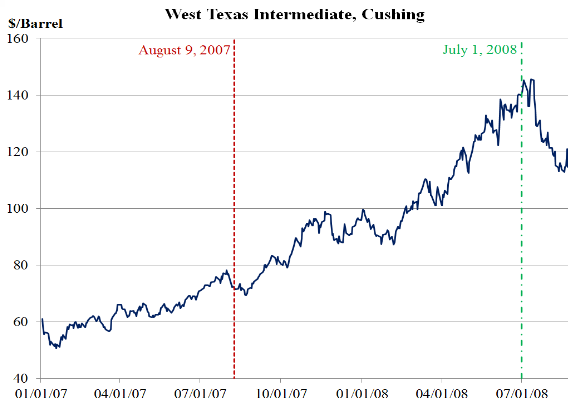

FIGURE: Oil prices (WTI) increased from about $70 per barrel when the crisis began to more than $140 per barrel the following summer.

MAGNITUDE OF THE OIL PRICE SHOCK

- As of the beginning of the crisis, August 9, 2007, year-over-year oil prices had declined close to 4 percent.
- By the middle of June 2008, year-over-year oil prices were up more than 100 percent, a doubling of the price of crude oil in about 10 months.
- This oil price shock contributed to the slowdown in the U.S. economy in the second half of 2008.

Real-time data

Recession dating

- Recessions are dated only long after the fact by an unofficial "NBER dating committee."
- The recession during this period was later dated as beginning in December 2007.
  - Incidentally, this is 10 months *before* Lehman-AIG.
- However, during 2008 there was a debate as to whether the U.S. was in recession or not.
- Based on the data at the time, the outcome of that debate was far from clear.
- The real GDP data suggested that Fed easing had mitigated the crisis up to mid-2008 and that the U.S. had perhaps avoided recession.

Real-time data

- As of early August 2008, the growth picture for the U.S. economy according to available real-time data was relatively good.
- In particular, estimates of real GDP growth were modest but positive for 2007 Q4, 2008 Q1, and 2008 Q2.
  - *There was no recession according to the conventional definition of two consecutive quarters of negative GDP growth.*
- As of July 10, 2008, forecasts for the second half of 2008 were for continued modest growth.
- According to today's data, real GDP growth in the first quarter of 2008 was steeply negative, but this information was not available at that time.
- There was a good case to be made that the "muddle through" scenario, which had apparently been correct for an entire year, would continue through the end of 2008.

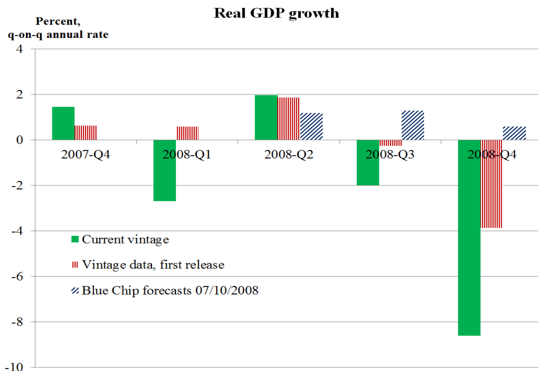

FIGURE: The real GDP data available as of August 2008 suggested the U.S. economy continued to grow at a modest pace. Forecasts predicted more of the same.

THE EFFECTS OF HIGHER OIL PRICES

- At the end of 2007, light motor vehicle sales were at an annual rate of close to 16 million.
- By July-August 2008, sales had fallen to an annual rate of close to 13 million, and were continuing to fall.
- Forecasters started to realize that the economy was slowing more appreciably than had been expected.
- The slower economic growth made the financial crisis much worse.

Bear Stearns

BEAR STEARNS

- In March 2008, failing Bear Stearns was purchased by J.P. Morgan, with the help of the Fed.
- Bear Stearns was the smallest of the five large investment banks in the U.S.
- In fact, Bear Stearns was only 34th on the list of U.S. financial firms ranked by 2007 revenues.

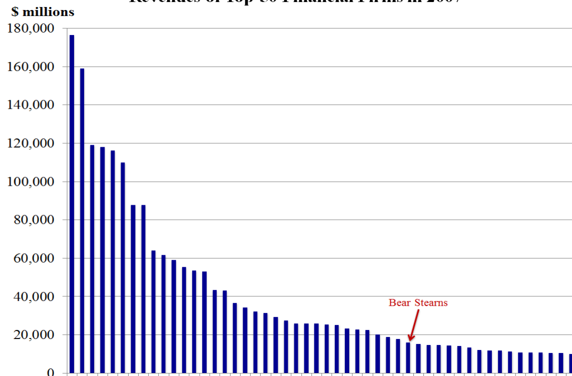

FIGURE: Bear Stearns was ranked only 34th by revenue among financial firms in the U.S. in 2007. *Source*: Fortune 500.

Two problems with Bear Stearns

- One problem with the Bear Stearns deal was that it suggested all financial firms larger than Bear had some form of implicit insurance from the Fed.
  - In the absence of any formal policy announcement, it was unclear whether the Fed had the intention or the wherewithal to offer insurance to such a large group of firms.
- The other problem with the Bear Stearns deal: It was successful in the sense that market volatility declined substantially following the deal.
  - This success suggested that the Fed could buy time to allow the economy to get past the financial crisis by encouraging stronger firms to buy weaker firms in imminent danger of failure.
  - This “marriage model” might have worked, had there not been so many marriages to arrange.

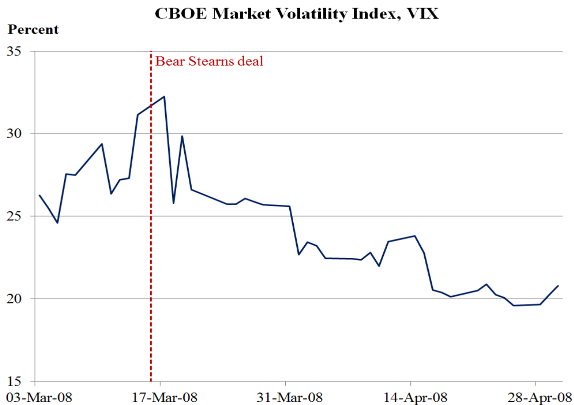

FIGURE: The VIX volatility index declined after the Bear Stearns deal.

Lehman and AIG

What to do about Lehman?

- Lehman was the fourth largest U.S. investment bank, and was in the news all during the summer of 2008.
- Not all firms above Bear Stearns on the list of largest U.S. financials could reasonably be expected to receive assistance from the Fed, should many of them be in danger of imminent failure at once.
- Investors had a year to prepare for a possible Lehman bankruptcy.
- It looked like the U.S. economy had made it through the first year of the crisis with slow growth but without a conventionally-defined recession.
- The possibility existed that a Lehman "marriage" could not be arranged on satisfactory terms, in which case the firm would have to go to bankruptcy.

AIG rising

- AIG was not considered vulnerable by most observers until September 2008.
- Few appreciated the firm's situation.

Forced marriage model fails

- The Lehman failure by itself was not particularly surprising and the U.S. economy could have coped with this single event.
- What was relatively surprising was that AIG, one of only a handful of triple-A-rated firms in the U.S., was also in incredibly deep trouble.
- This brought all financial firms under vastly increased suspicion and drove the financial crisis from mid-September 2008 onwards.
- We will do history a favor if we refer to this event as "Lehman-AIG" and not just "Lehman."

The zero lower bound

The zero lower bound

- The federal funds rate began trading near zero in September 2008.
- The FOMC decided to change the target policy rate to a range of $0 - 25$ basis points in December 2008, where it remains to this day.
- The debate over the wisdom of locking in near-zero rates did not take sufficient account of the experience in Japan, in my view.
- The BOJ changed the policy rate to near zero in the 1990s.
  - Short-term rates remain at zero today in Japan, 15 years later.

Coming off the zero lower bound

- Some analysis suggests that the sooner policymakers set the policy rate to zero, the sooner the economy will recover and the sooner interest rates can be returned to normal.
- I have seen no evidence that this is true during the last five years.
- Instead, I think the December 2008 FOMC decision unwittingly committed the U.S. to an extremely long period at the zero lower bound similar to the situation in Japan, with unknown consequences for the macroeconomy.

QUANTITY TARGETS

- As 2008 ended, the debate shifted to post-ZLB arguments.
- The key question became, "How should monetary stabilization policy be conducted with the policy rate at the zero lower bound?"
- The outcome of that debate over the last five years has produced two answers:
  - Forward guidance.
  - Quantitative easing.
- But those are topics for another day.

Conclusion

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- The summer of 2008 has developed a notorious reputation because it preceded Lehman-AIG.
- I have tried to offer some perspectives on the nature of the macroeconomic situation during 2008.
- At the one-year anniversary of the financial crisis, in August 2008, it appeared that the U.S. had weathered the crisis reasonably well, and that continued slow growth was likely.
- However, the effects of the commodity price boom during the preceding year, peaking in July 2008, contributed to a slowing economy during the third quarter of 2008.
- This greatly exacerbated the financial crisis and led to multiple financial firm failures.