The Subprime Turmoil: What’s Old, What’s New, and What’s Next

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February 13, 2009
Historical Approach: Summary

• If you look at subprime crisis through the lens of historical real estate related banking crises, are its origins and its propagation surprising or old hat?

Origins
• Largely old hat. Loose money (low real rates) and housing subsidies delivered via leverage (F&F).
• New element: Huge buy-side agency problem.
• Regulation: Not just a leverage arbitrage story about MBS and IBs, but a deeper risk mis-measurement story.

Propagation
• What’s old? Liquidity-shocked credit spreads and quantity rationing in money markets.
• What’s new?
  – Protracted uncertainty about incidence of losses, reflecting nature of subprime assets and their securitization.
  – Capital raising, reflecting bank structure and deregulation.
  – Aggressive government intervention.
2002-2005 Taylor Rule

Federal Funds Rate and Inflation Targets

Calculated federal funds rate is based on Taylor’s rule. See notes on page 19.