Anil Kashyap comments on Narayana Kocherlakota

Two Models of Land Overvaluation and their Implications

Jekyll Island, November 6, 2010

1. Comments on the basics of each model

2. Extensions
   - Link to the current crisis
   - Robustness?

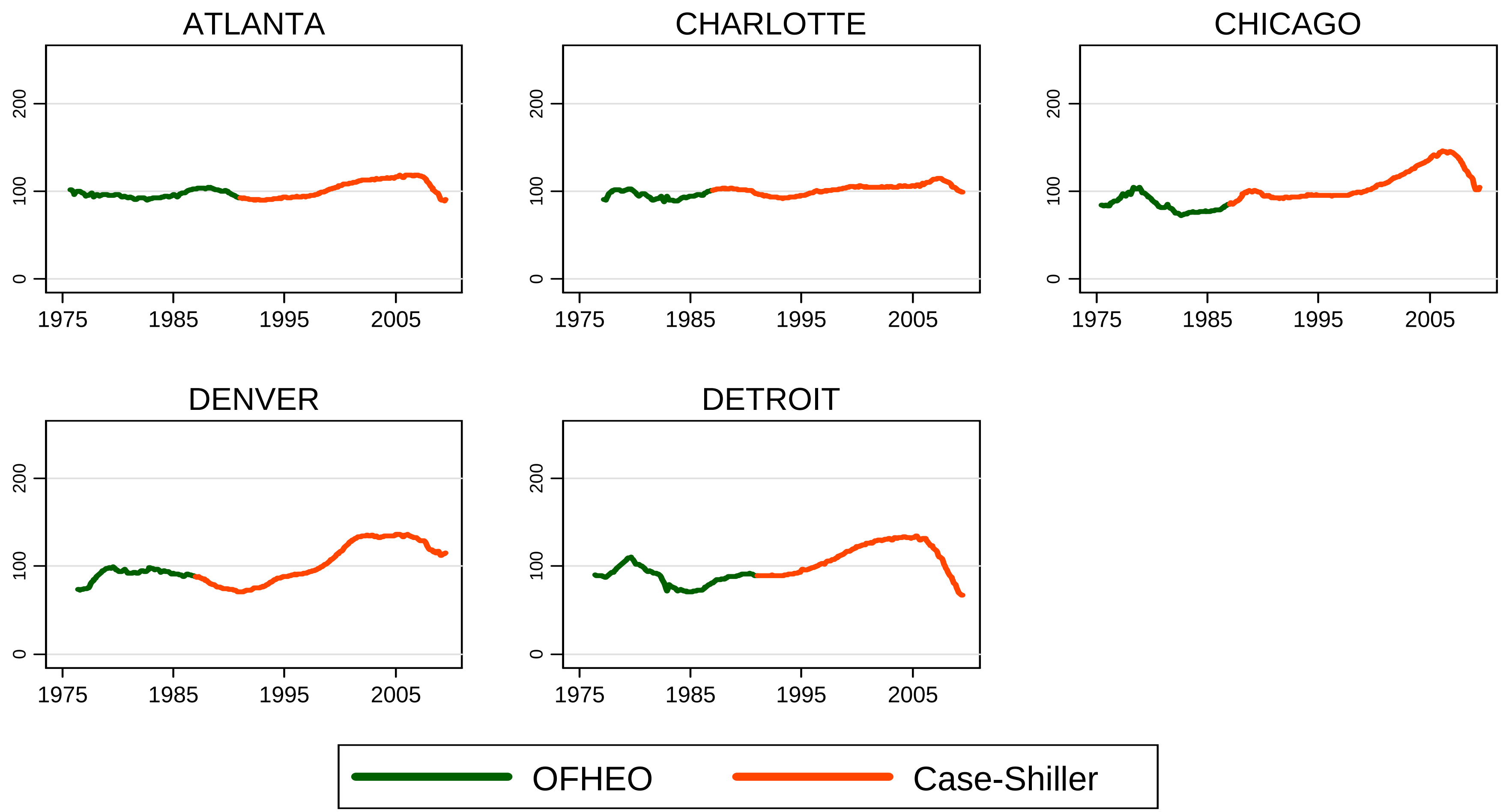
The University of Chicago Booth School of Business

Model 1: Debt Guarantees

- Refreshing to see standard economics deployed creatively
  - That the rents flow to scarce factor is well understood and non-controversial

- The rents going to the scarce factor has some empirical support in the most recent crisis

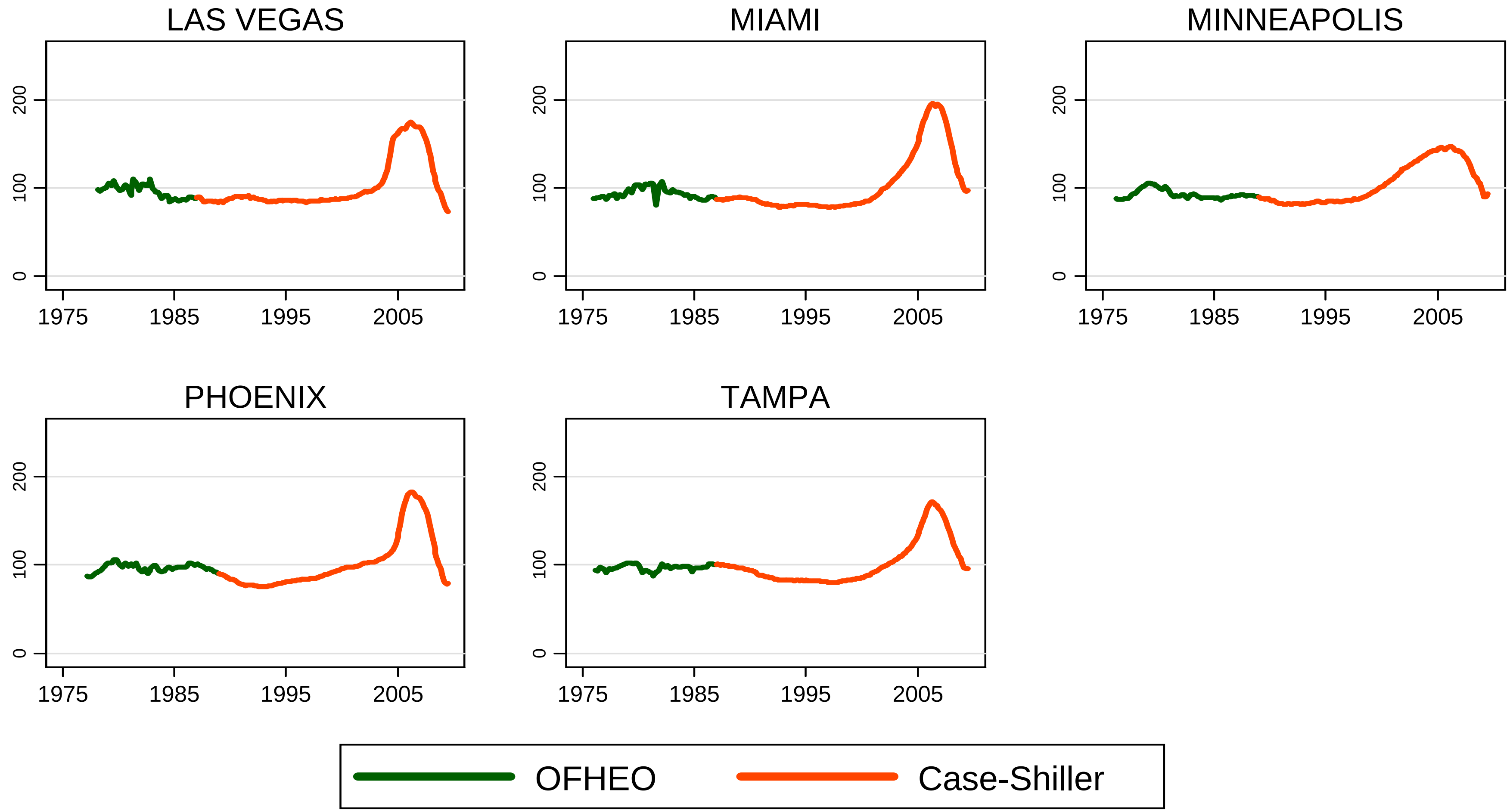
House Prices in Steady Markets (from Chris Mayer)



Source: OFHEO, Case-Shiller Index and BLS
OFHEO Index Current as of Quarter 2 2009
Case-Shiller Index Current as of July 2009
Real Home Price Index

CHICAGO BOOTH
The University of Chicago Booth School of Business

House Prices in “Bubble” Markets (from Chris Mayer)



Source: OFHEO, Case-Shiller Index and BLS
OFHEO Index Current as of Quarter 2 2009
Case-Shiller Index Current as of July 2009
Real Home Price Index

CHICAGO BOOTH
The University of Chicago Booth School of Business

Table 1: Real annualized house price growth, 1950-2000,
Top and Bottom 10 MSAs with 1950 population>500,000

Top 10 MSAs by Price Growth Annualized growth rate, 1950-2000		Bottom 10 MSAs by Price Growth Annualized Growth Rate, 1950-2000	
San Francisco	3.53	San Antonio	1.13
Oakland	2.82	Milwaukee	1.06
Seattle	2.74	Pittsburgh	1.02
San Diego	2.61	Dayton	0.99
Los Angeles	2.46	Albany (NY)	0.97
Portland (OR)	2.36	Cleveland	0.91
Boston	2.30	Rochester (NY)	0.89
Bergen-Passaic (NJ)	2.19	Youngstown-Warren	0.81
Charlotte	2.18	Syracuse	0.67
New Haven	2.12	Buffalo	0.54

Population-weighted average of the 50 MSAs in this sample: 1.70

Notice sustained booms only possible where supply responses are limited. Stagnation can happen anywhere.

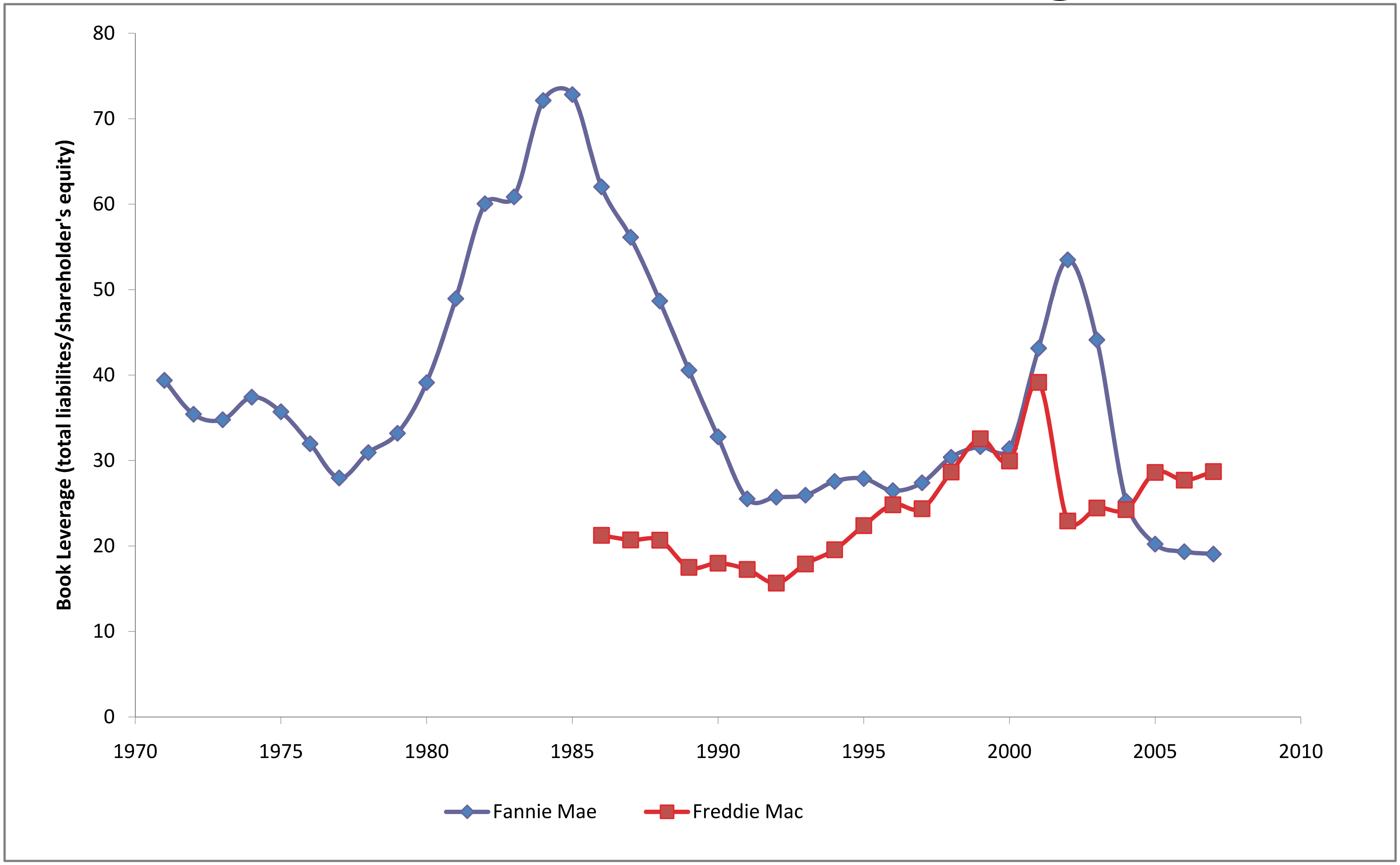
CHICAGO BOOTH
The University of Chicago Booth School of Business

Debt Guarantees and the Recent Crisis

- Why did the bubble show up now, did the subsidy change?
  - Is this really about Fannie and Freddie, and the debate over whether the drive for affordable housing was critical

- It seems like intuition on importance of leverage is very general, how might we control leverage?
  - Would attending to the left tail really amount to anything more than rule based on recent credit growth?
  - The political economy of using leverage restrictions is challenging
  - Have also to be very careful about imposing leverage restrictions only on banks ➔ shadow banking system growth!

Fannie and Freddie Leverage



*Source: Compustat. Fannie and Freddie both had negative book equity value in 2008, so this data point is not displayed.

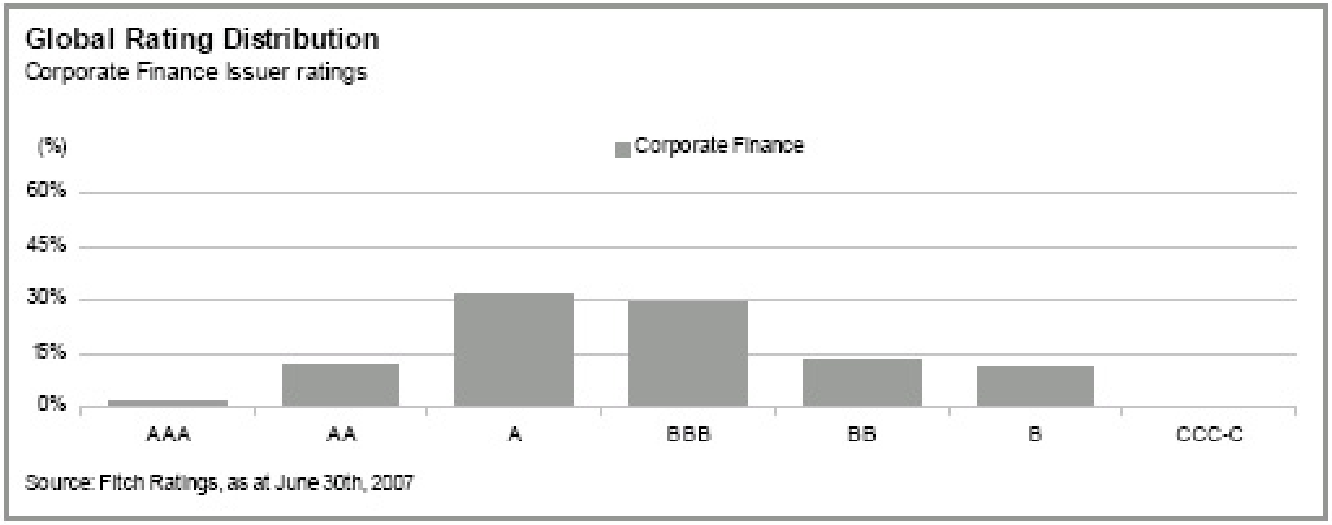
The University of Chicago Booth School of Business

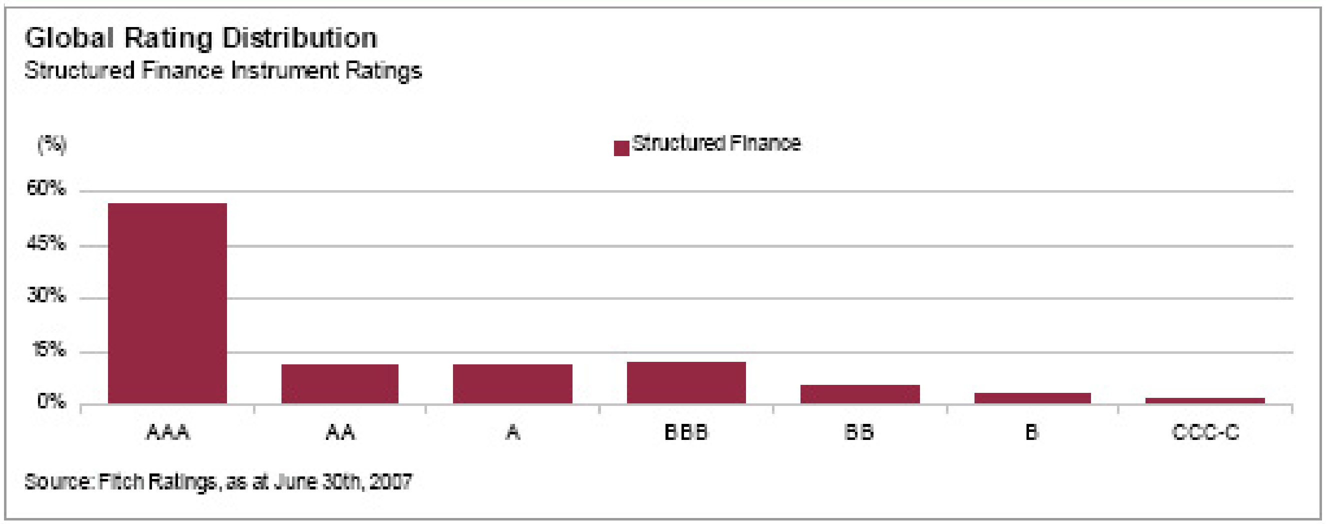
Model 2: Rational Bubbles

- Again standard theory: just need to be on the "wrong side" of the golden rule so that $r < g$
  - If so "riding" a bubble is risky but appealing

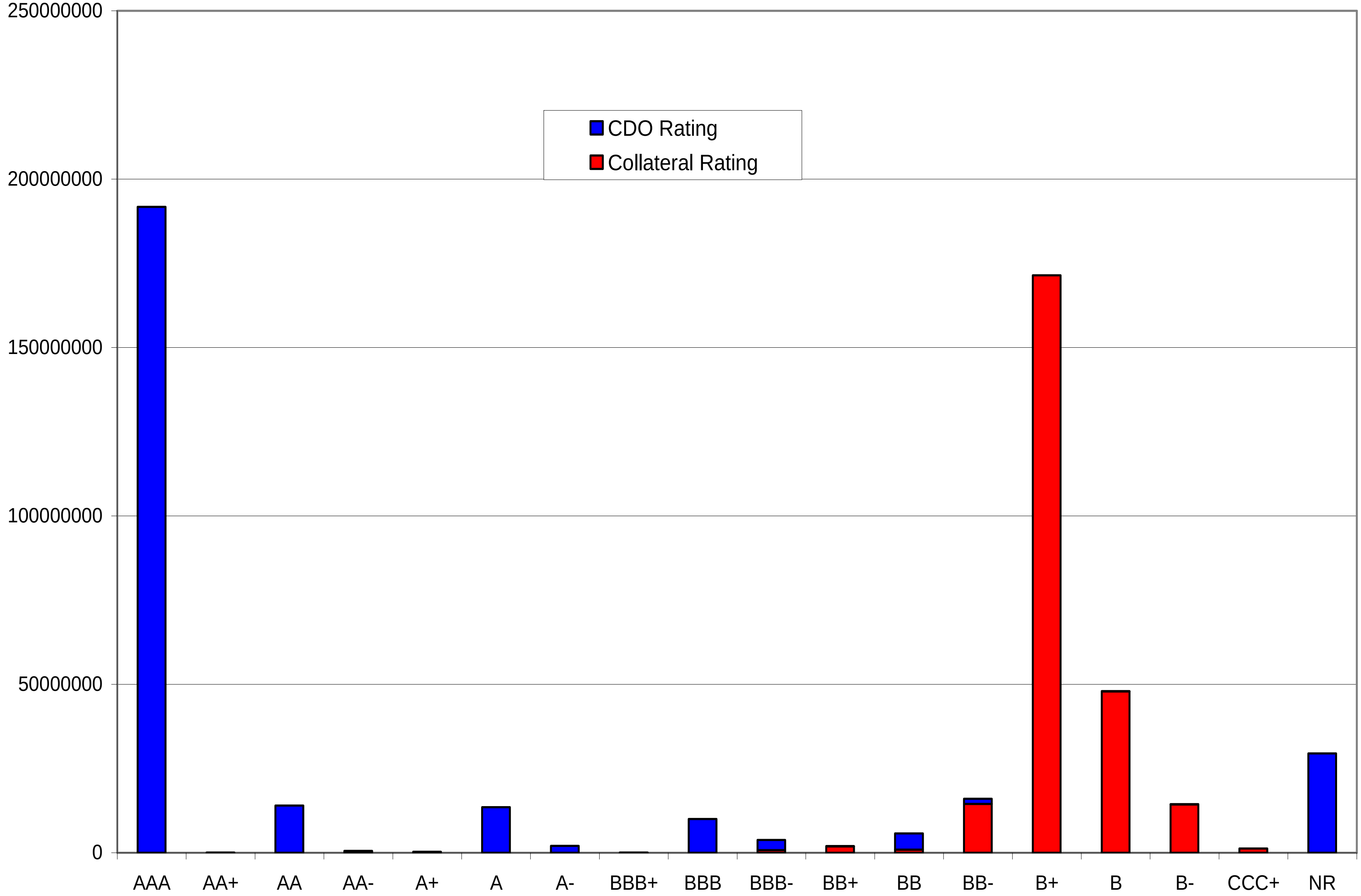
- Again one reading of the current crisis suggests the expansion in the supply of securities was important
  - Note the explosion of AAA

AAA-rated securities





CDO credit rating vs. Collateral rating (3,912 tranches)



CHICAGO BOOTH

The University of Chicago Booth School of Business

Rational/Irrational Bubbles…

- Di we trust the government to migrate the bubble?
  – Huge incentives to play this card

- What if it is not a rational bubble?
  – Shleifer-Vishny, sentiment and unstable banks

- What if we anticipate ex-post bailouts?
  – Ex-ante incentives change, potentially a lot

Conclusions

- The paper is a paragon of transparency, great benchmark for policy analysis

- Nice starting point for discussing several important issues.

- Not so sure about robustness….