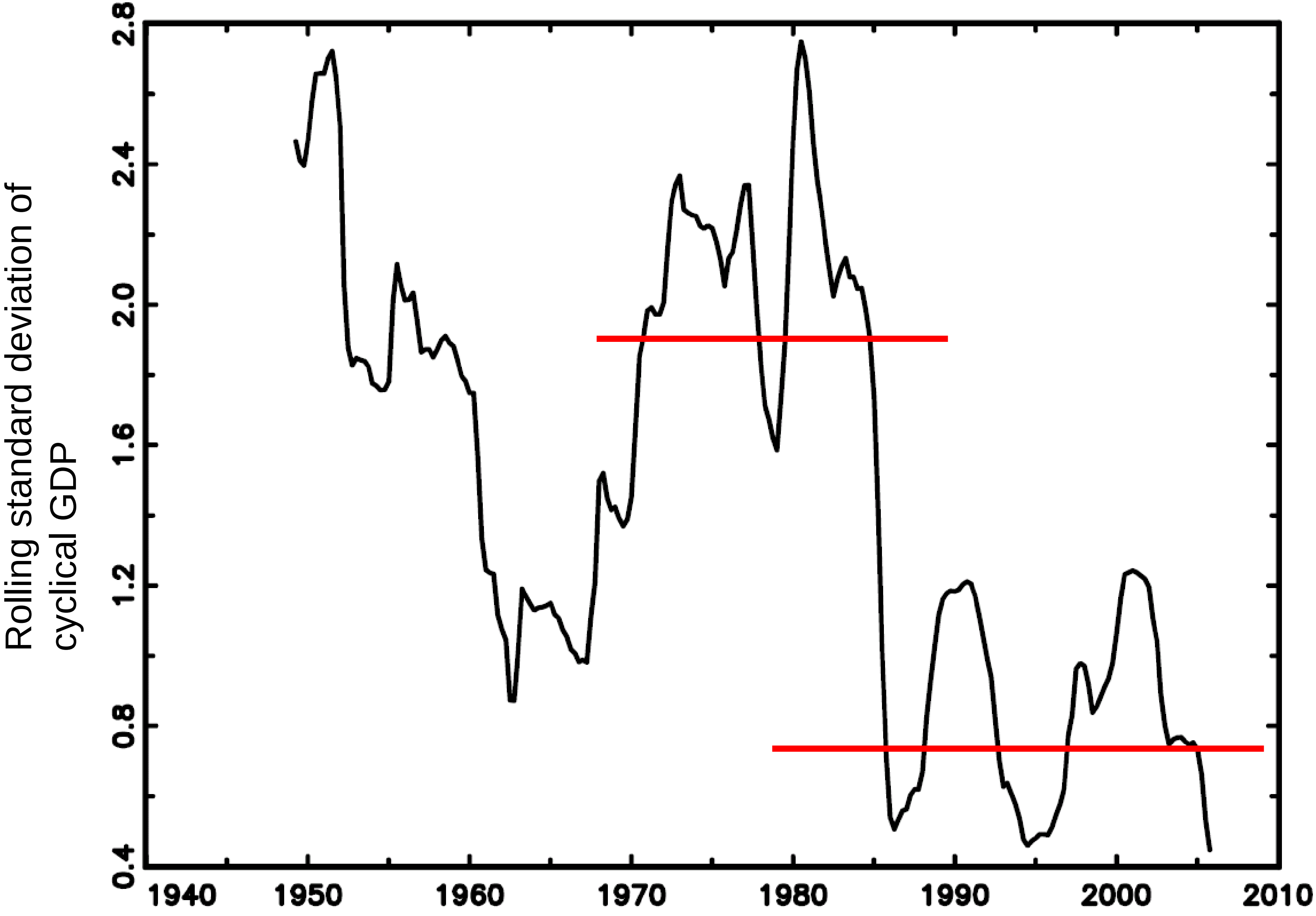
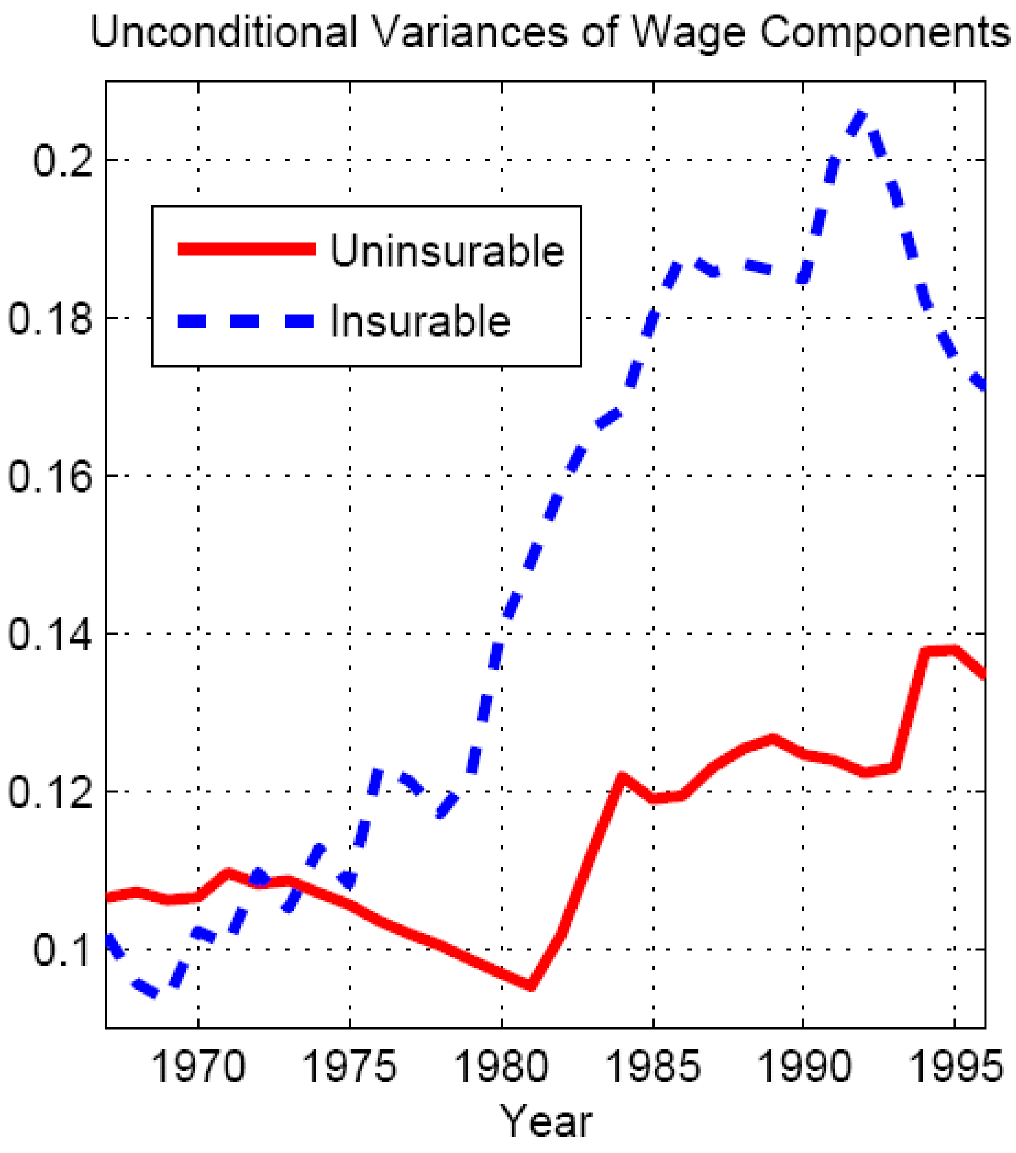
A Credit Crunch Interpretation

Morten O. Ravn
EUI and CEPR

MACRO MODERATION



MICRO EXAGGERATION



RISK AND OPPORTUNITIES

In terms of lending:

- decreasing aggregate (correlated) risk +
- increasing idiosyncratic risk

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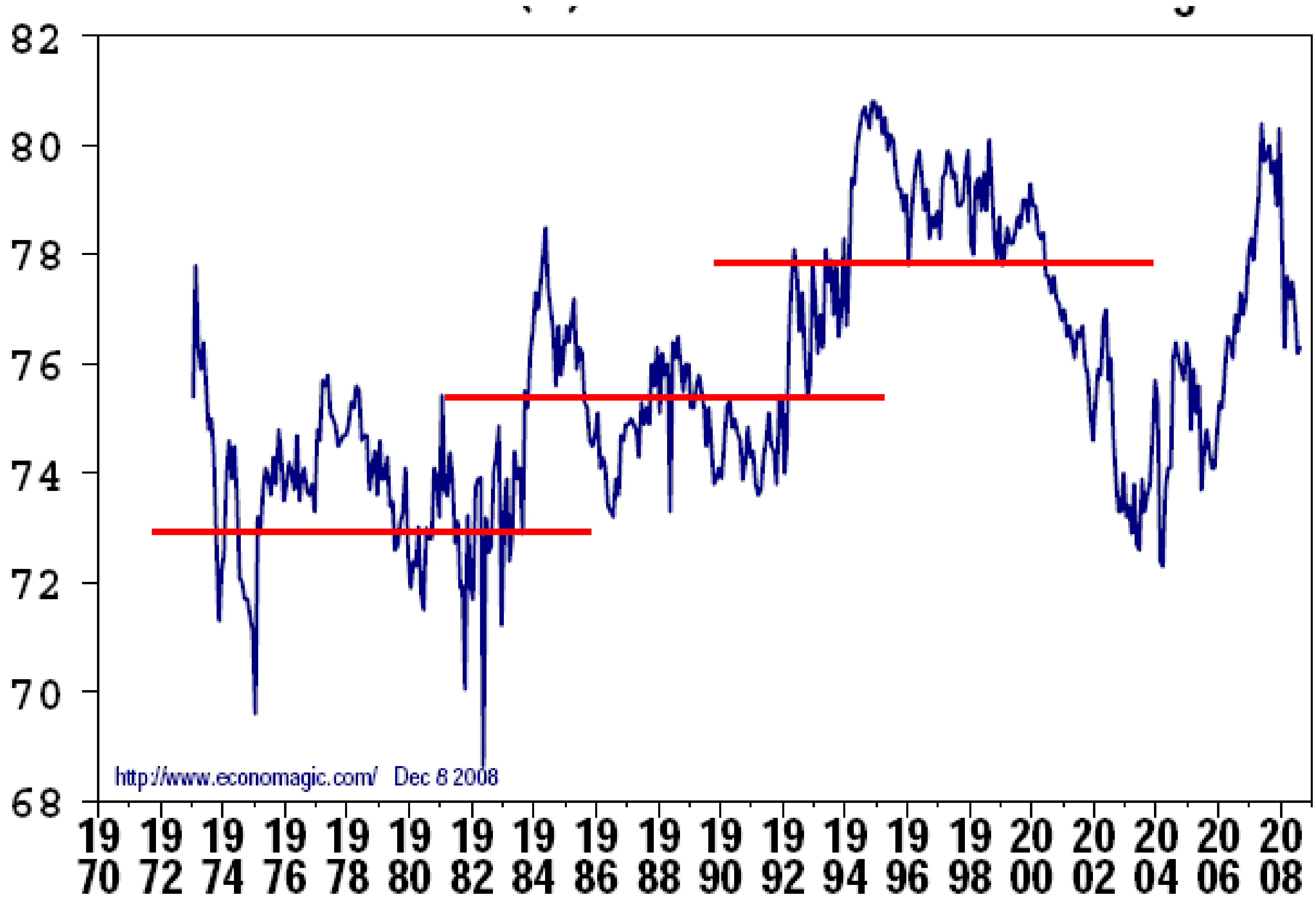
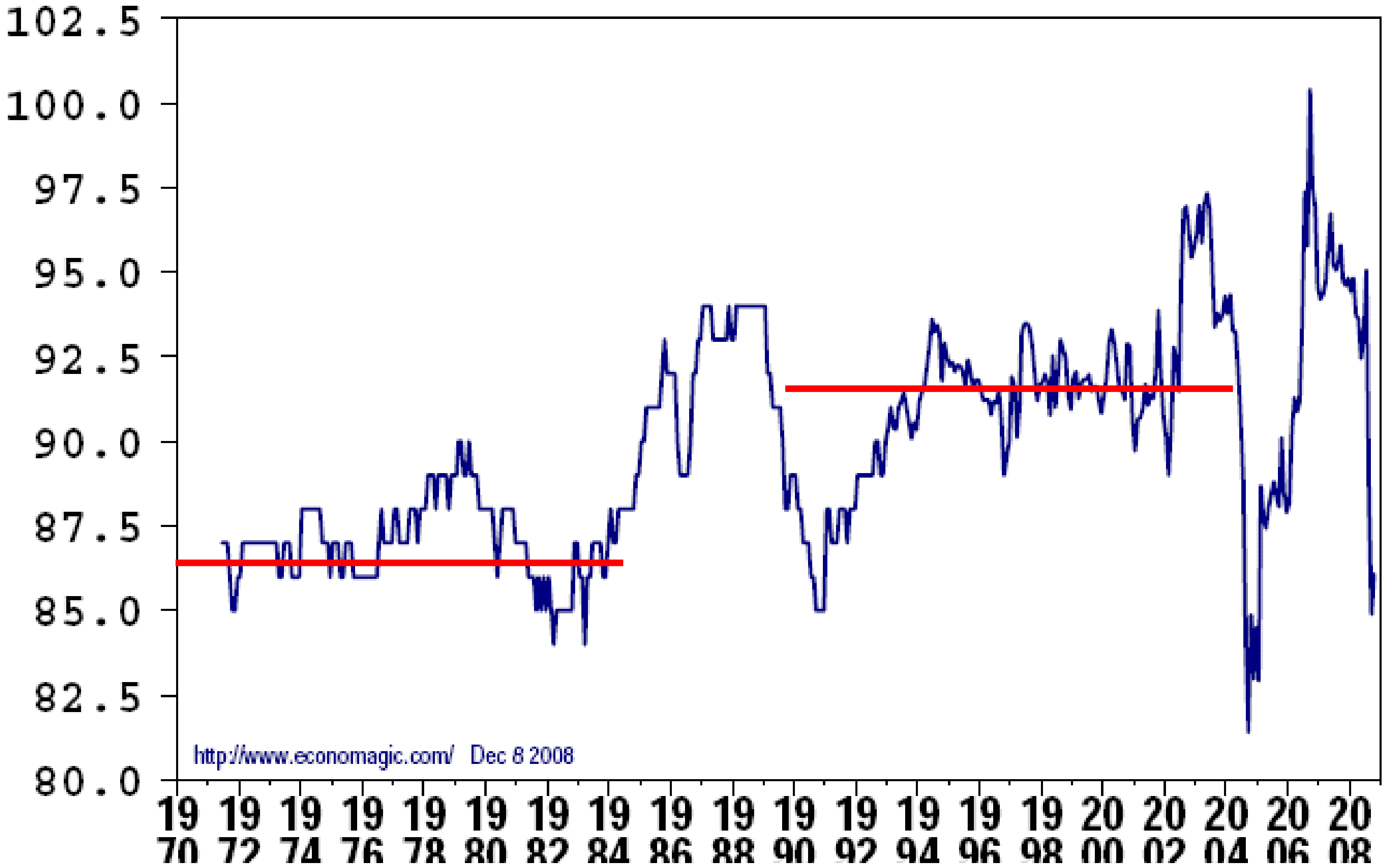
- increased opportunities for asset (loans) insurance
  - securitization
  - increase in supply of risky loans

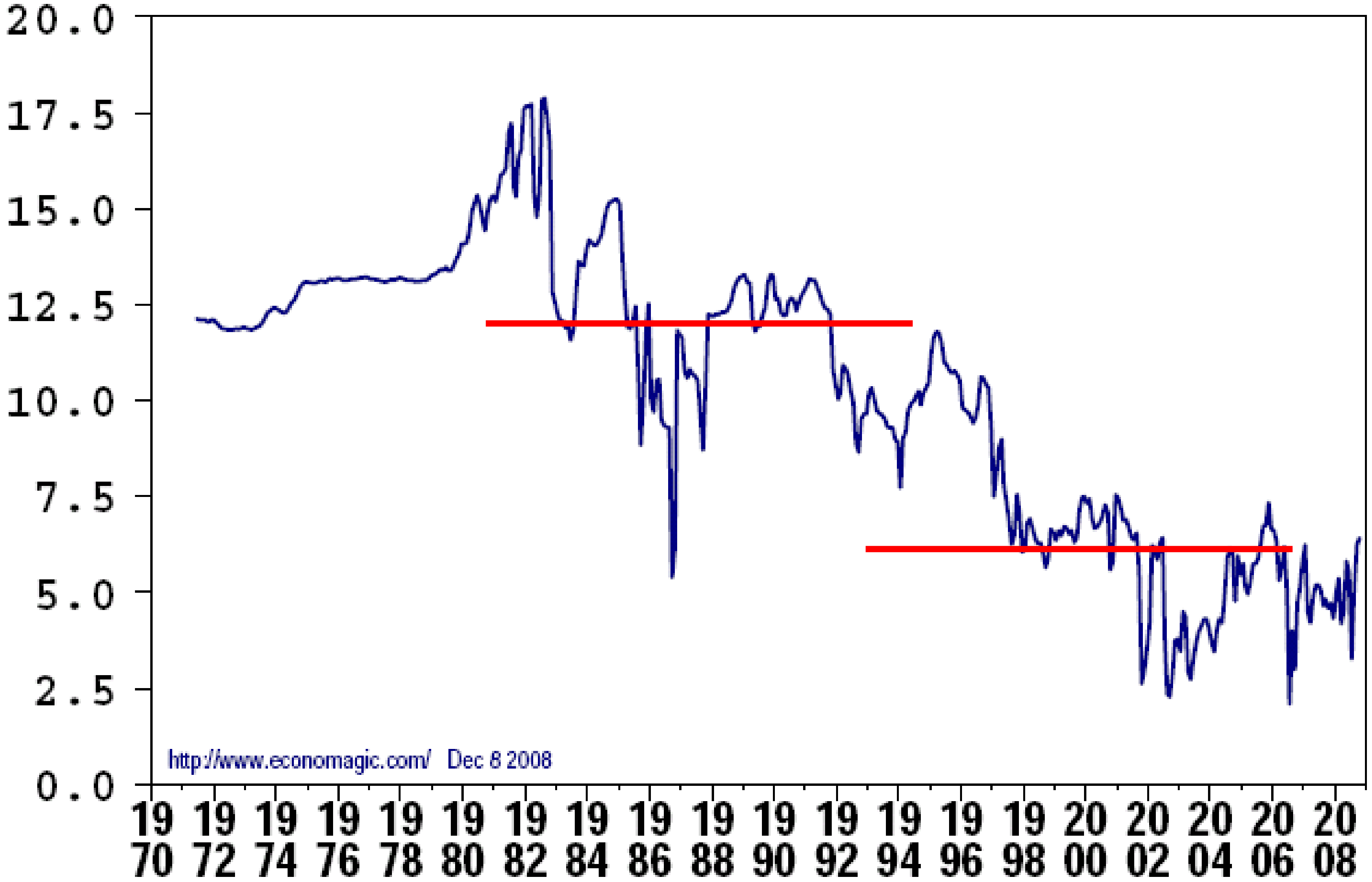
Loan-to-price, housing mortgages



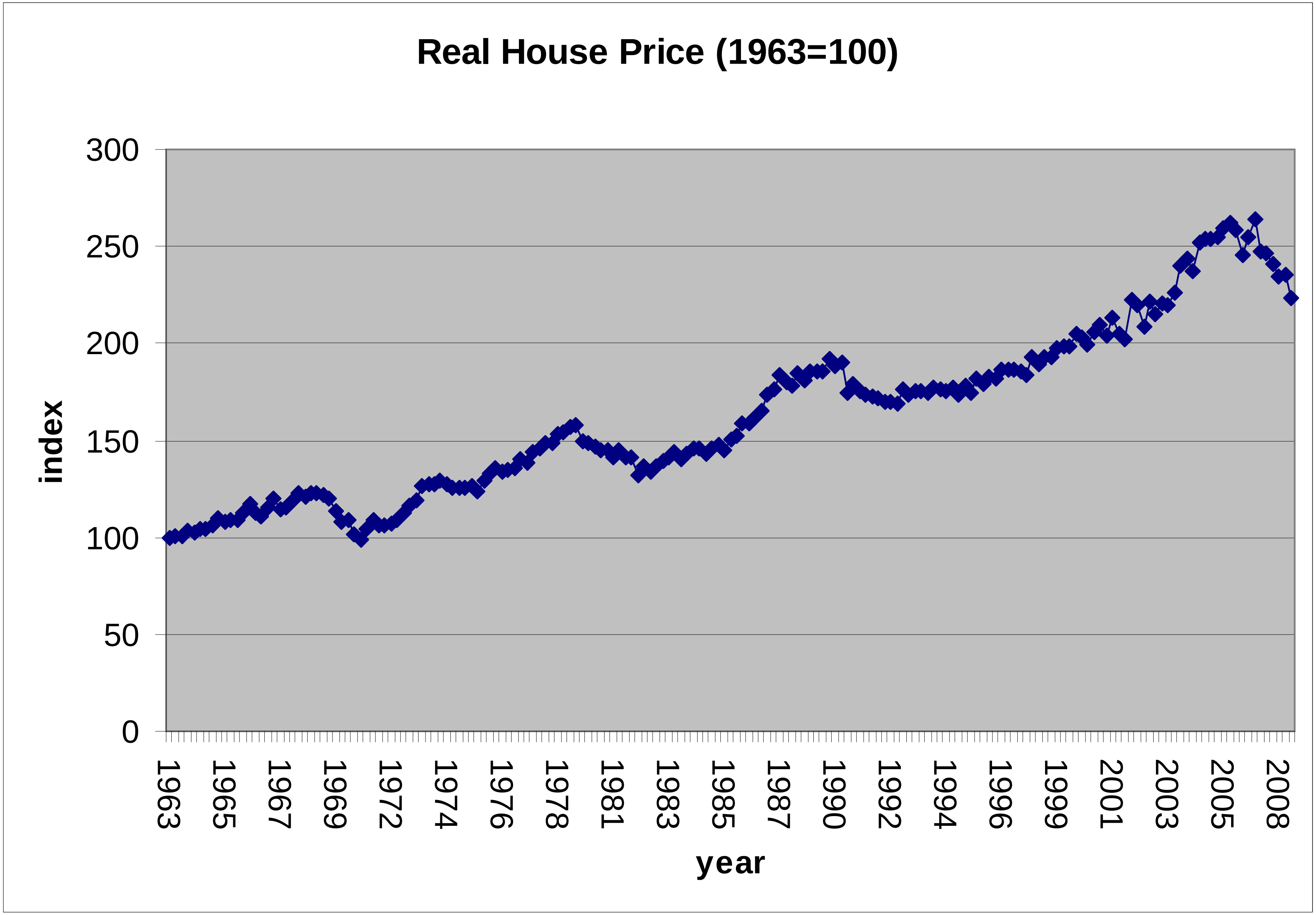
Loans-to-value, new cars



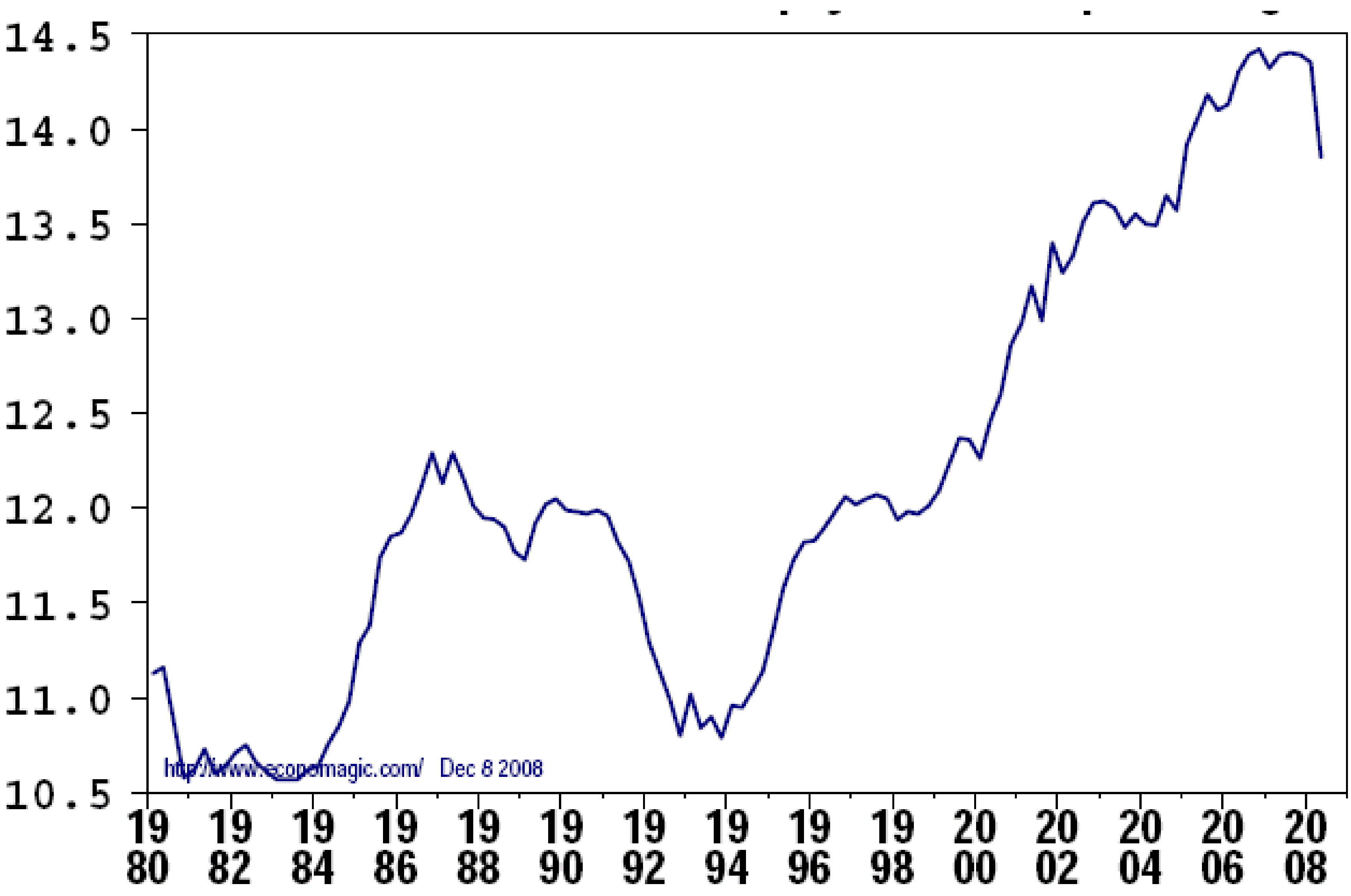
At cheaper rates – monetary policy



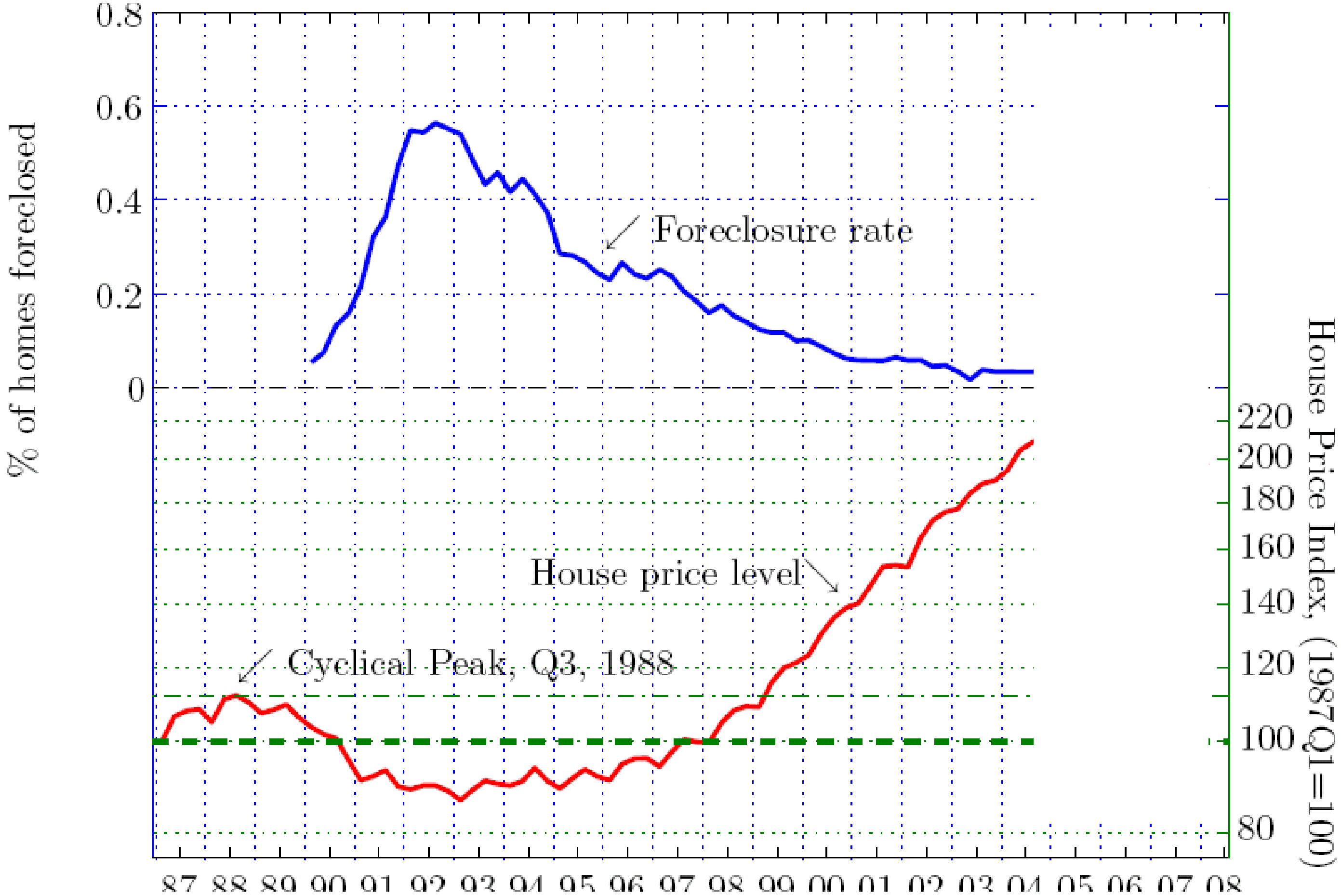
And increasing house prices



Giving rise to increasing household debt



So despite increasing indebtedness and increasing earnings risk, foreclosure rate was minimal

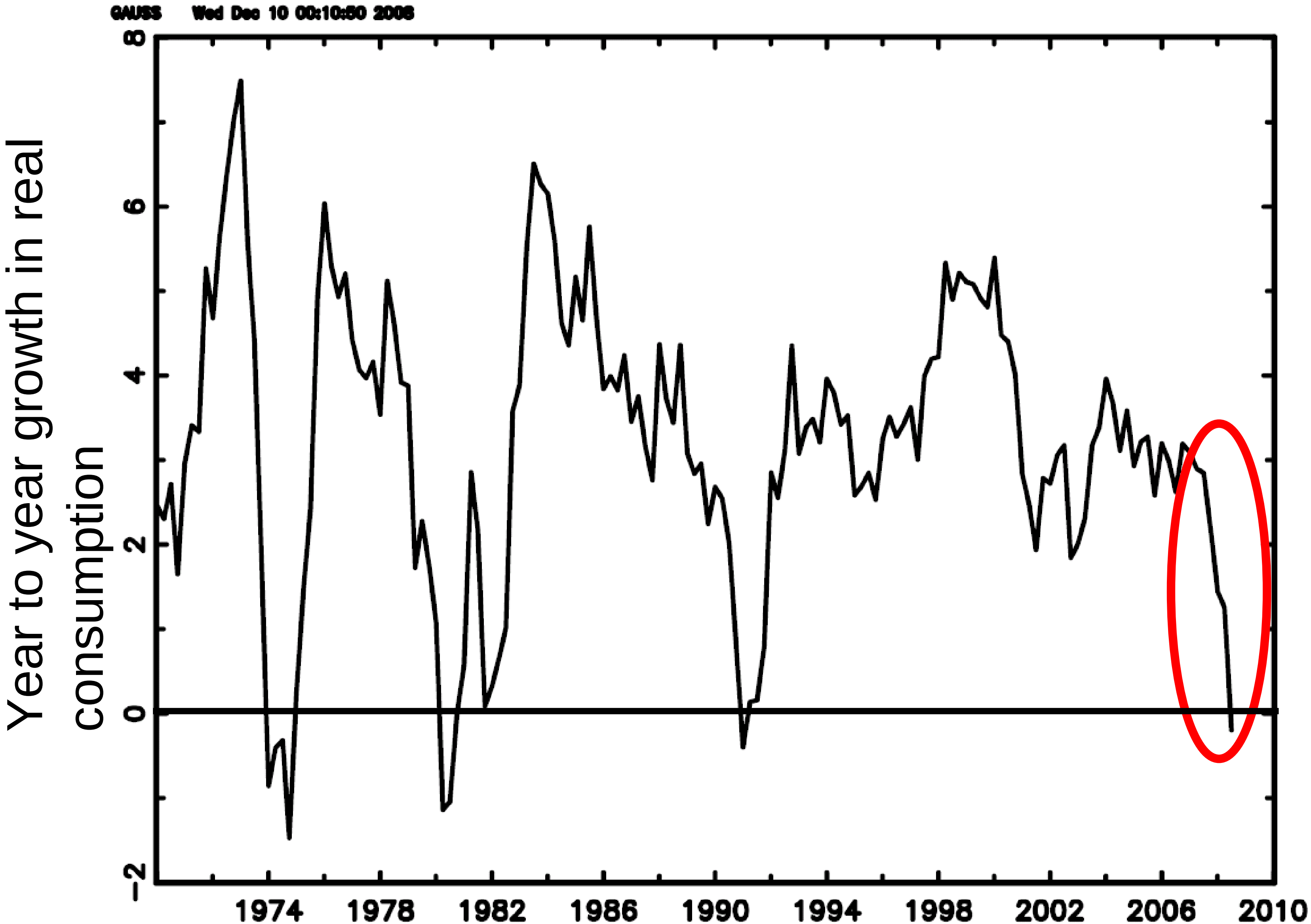


MY INTERPREATION

So:

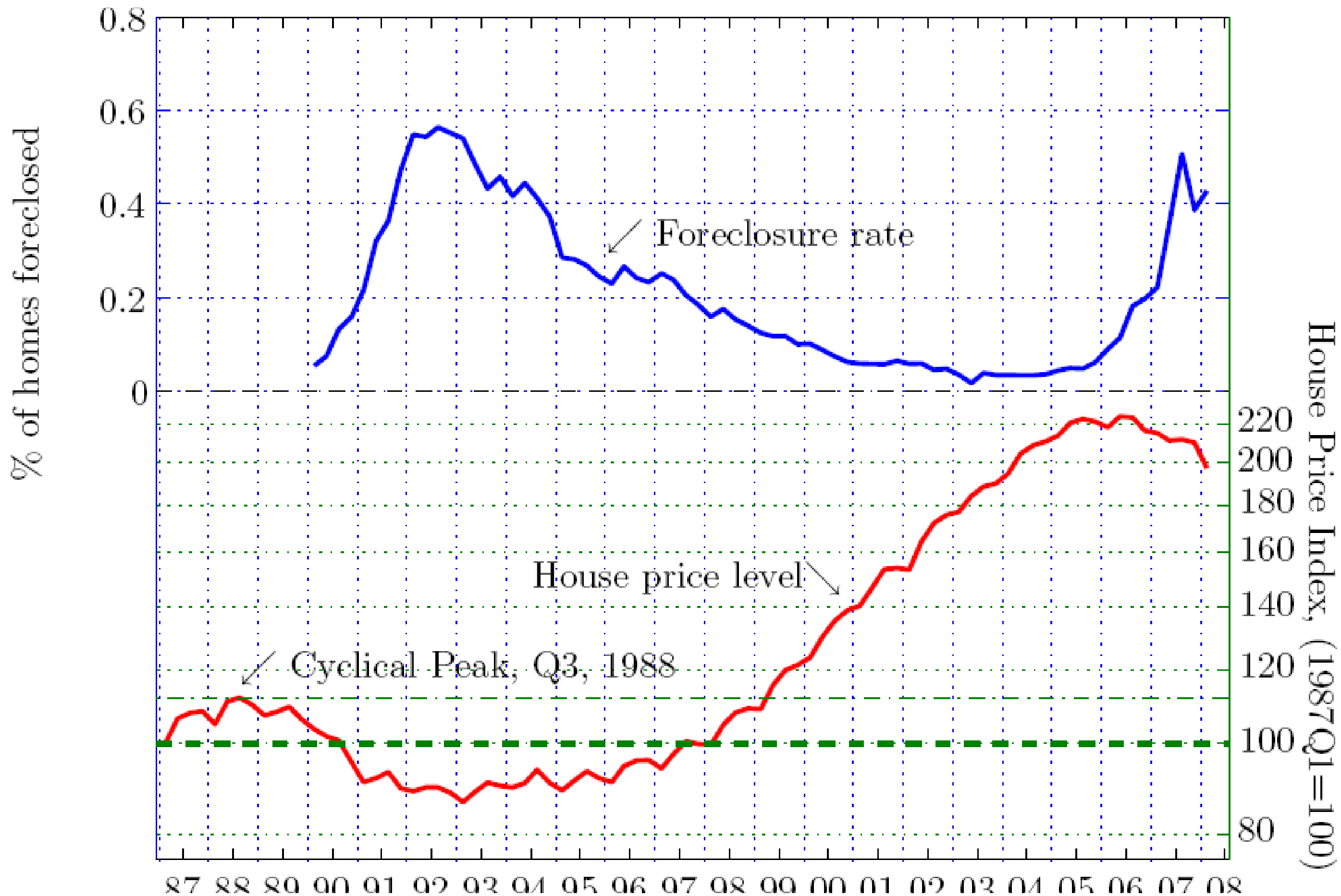
- illusion of little or no aggregate risk
- households willing to borrow more due to low rates, capital gains, and positive outlook on the future
- financial institutions willing to lend more due to securitization and to household's increased ability to commit to no-default
- investment banks and others making lots of money insuring contracts with no default – close to a pure arbitrage

But then



GAUSS Wed Dec 10 00:10:50 2008
8
6
4
2
0
-2
1974
1978
1982
1986
1990
1994
1998
2002
2006
2010
Year to year growth in real consumption

And risk went up!



MY INTERPREATION

But:

- what happens when a macro shock arrives:
  - insurance contracts cannot deal with aggregate risk
  - those that had sold insurance contracts had nominally very large liabilities
    - default of insurers
    - those that had bought the insurance must bear the risk which they thought was not there

WERE MISTAKES DONE?

YES:

- Systematic underestimation of the riskiness of the loans – the business cycle is not dead.
- rating agencies again did very badly
- regulators also underestimated the risk
- too much faith in backward looking estimates of risk
- Europe needs to think about coordinated supervision and lender of last resort issue