

Franco German Council of Economic Advisors

Macroeconomic Impact of the Subprime Crisis

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Approach

- Assuming a strictly macroeconomic point of view
 - Thinking in aggregates
 - Observing both sides of the market
 - Sector perspective and circular flows

- Theoretical and empirical aspects
 - Theory as driver for (more) empirical research
 - Numerical quantities for assessing potential impact (qualifying the numbers)

⇒ **General view: Macroeconomic risks are overstated**

Major aspects of analysis

- (1) Asset market prices and economic wealth**
- (2) Response of institutional sectors to wealth fluctuations**
- (3) Technical impact on financial system**
- (4) News and expectation formation**
- (5) Additional aspects**

(1) Asset market prices and economic wealth

- Housing market
 - Financial asset markets
 - Equity capital
 - Liabilities and derivatives (domestic and foreign)
- ⇒ To what extent do asset price fluctuations imply variations in economic wealth (losses or gains)?

Technical remark:

Write-offs within the financial sector do not directly matter for GDP or GNI (revaluations within the financial accounts)

Residential housing as an economic asset

- Economic value stems from capacity to provide services (= provision of living space)
- This capacity was not affected by the subprime crisis (trivial, but true: the houses are still there)
- Stock effect of general housing price movements
 - Housing occupied by owner:
No effective wealth effect
 - Rented housing :
Wealth shift effect (between owners and tenants)
- Flow effect of general housing price movements
 - Positive linkage between relative housing prices and construction activity
 - Wealth shifting might have an expenditure effect, if propensities to consume of owners and tenants differ

Financial assets and wealth 1

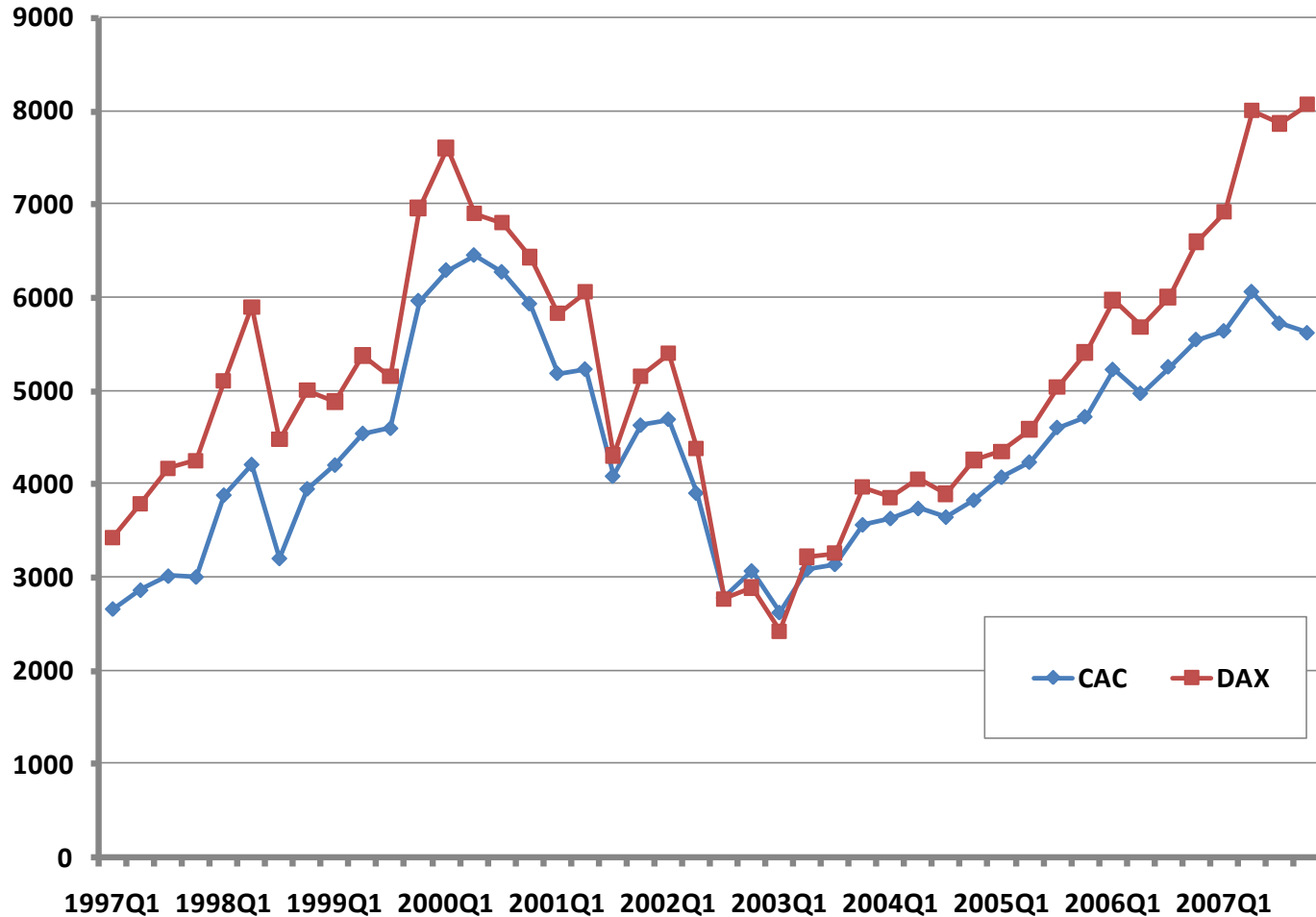
- Financial assets: Securitization of the real capital stock
- Capital stock numbers (2007, bill. Euro)

	Germany	Eurozone
Fixed assets (total)	11.988	ca. 60.000
Fixed assets (housing)	5.723	
Stock market capitalization	DAX: 796	Total: 6.580

- Equity capital
 - Investors know about fluctuations
 - Expectation formation via smoothing rather than taking share prices at face values
 - CAC-40 | DAX-30 10-year average: +7,0 % | +7,2%
 - CAC-40 | DAX-30 4-year average: +16,7 % | +24,4%

CAC-40 and DAX-30

Index points



Financial assets and wealth 2

- **Liabilities and derivatives**
 - Zero-sum game (claims and liabilities cancel out)
 - Turbulences on the market for intra-financial liabilities might affect financial stability, but not the net wealth position of the real economy
- **But: Write-offs on foreign assets matter for domestic economy**
 - Direct wealth effect (lower future income flows)
 - Magnitudes?

(2) Response of institutional sectors to wealth fluctuations

- **Households**
 - private consumption
 - residential construction
 - **Companies**
 - investment (construction, M&E, other)
- ⇒ Empirical link between “gross” wealth fluctuations (stock market prices, housing prices) very weak for Germany and France
- ⇒ Real sector: Effective magnitude of potential losses induced by subprime crisis extremely low in terms of relative wealth effect

(3) Technical impact on the financial system

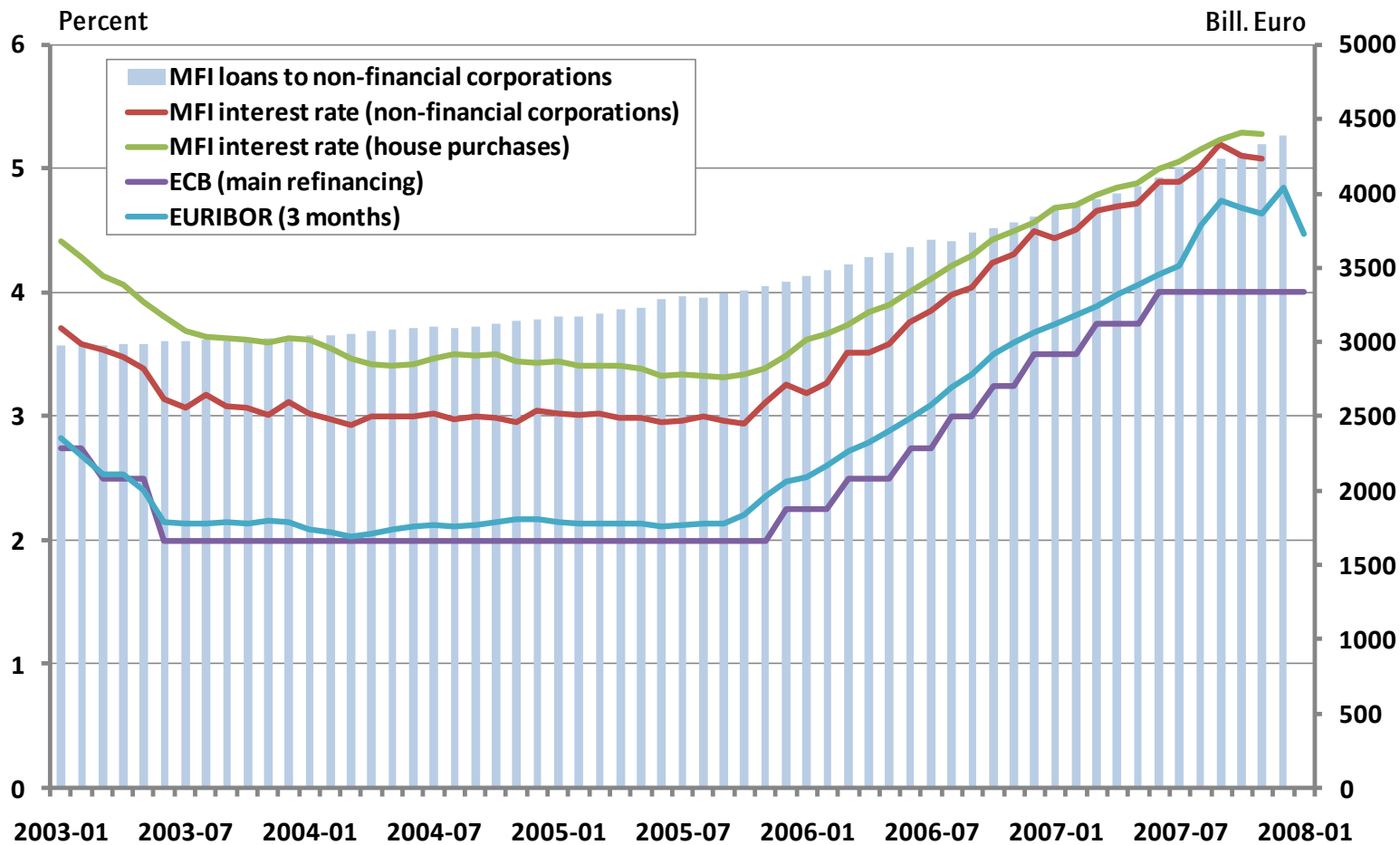
- **Credit formation capacity**
 - Monetary base
 - Capital base of the banking system (see next slide)
- **Confidence crisis and interest rates**
 - ⇒ Monetary base not affected
 - ⇒ MFI write-downs: 1 % of capital base = 16 bill. Euro
 - ⇒ So far, only poor evidence for NFI credit crunch problems
 - ⇒ No dampening effect of higher interest rates due to intra-financial confidence crisis
 - ⇒ Impact of housing prices on consumer spending via liquidity channel: evidence for liquidity constraints?

Eurozone MFI: Non-consolidated balance sheets

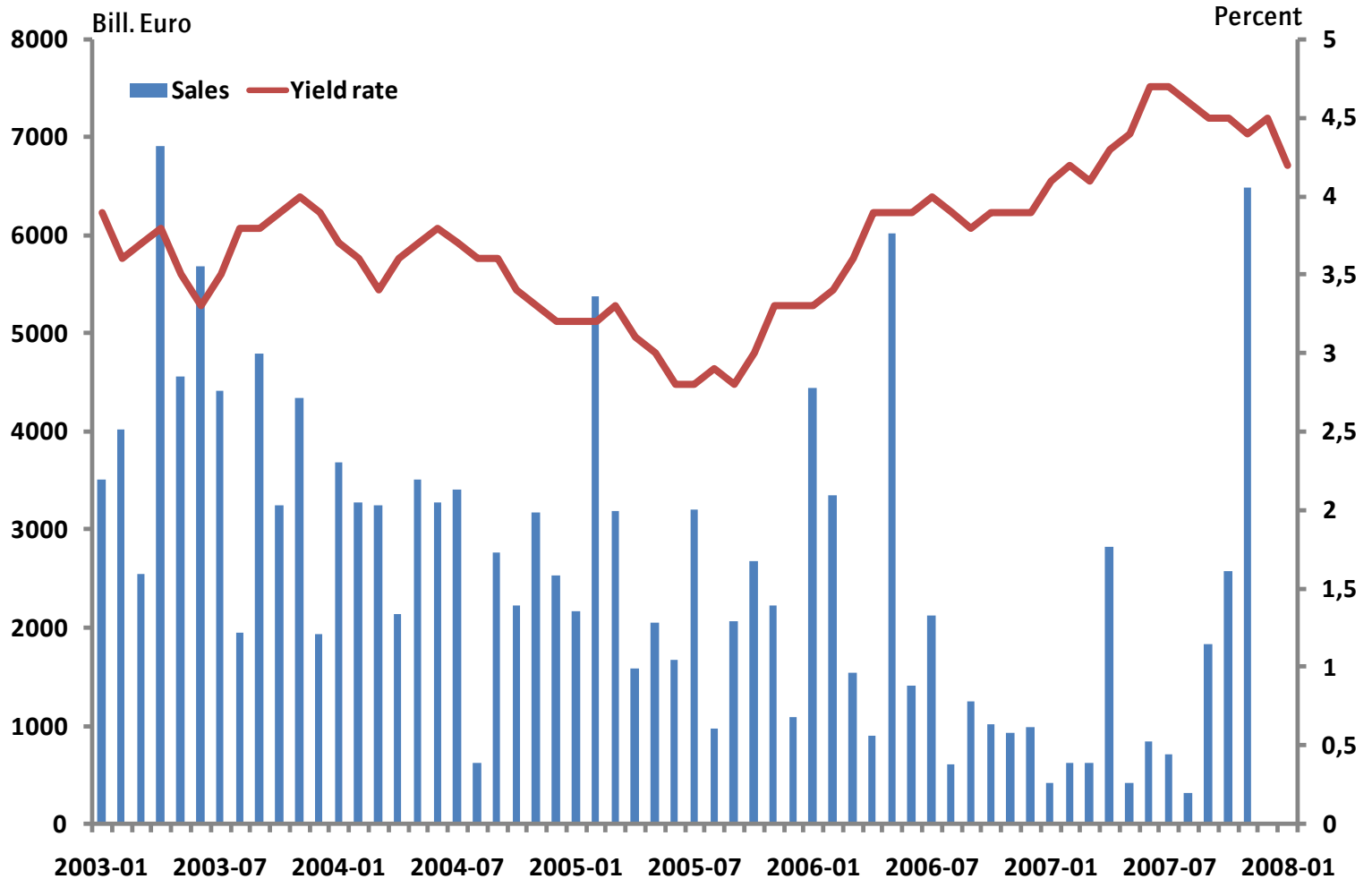
Bill. Euro (Dec. 2007)

1. Assets		2. Liabilities	
1.1. Loans to Euro area residents	16,876.9	2.1. Currency in circulation	0.0
1.1.1. Monetary Financial Institutions	5,774.9	2.2. Deposits of Euro area residents	15,077.5
1.1.2. General government	956.3	2.2.1. Monetary Financial Institutions	6,077.0
1.1.3. Other Euro area residents	10,145.7	2.2.2. Central government	128.2
1.1.3.1. Non-financial corporations 10)	4,383.2	2.2.3. Other general government/other Euro area residents	8,872.2
1.1.3.2. Households 7) 10)	4,807.5	2.2.3.1. Overnight	3,163.0
1.1.3.2.1. Consumer credit 10)	617.6	2.2.3.2. With agreed maturity	3,805.9
1.1.3.2.2. Lending for house purchase 10)	3,436.7	2.2.3.2.1. Up to 1 year	1,780.1
1.1.3.2.3. Other lending 10)	753.2	2.2.3.2.2. Over 1 and up to 2 years	203.6
1.1.3.3. Non-monetary financial intermediaries except insurance corporations and pension funds 10)	859.0	2.2.3.2.3. Over 2 years	1,822.3
1.1.3.4. Insurance corporations and pension funds 10)	95.9	2.2.3.3. Redeemable at notice	1,622.1
1.2. Holding of securities other than shares issued by Euro area residents	3,882.1	2.2.3.3.1. Up to 3 months	1,501.4
1.2.1. Monetary Financial Institutions	1,737.3	2.2.3.3.2. Over 3 months	120.7
1.2.1.1. Up to 1 year	374.2	2.2.3.4. Repurchase agreements	281.3
1.2.1.2. Over 1 and up to 2 years	142.3	2.3. Money market fund shares/units 9)	754.7
1.2.1.3. Over 2 years	1,220.8	2.4. Debt securities issued	4,639.3
1.2.2. General government	1,194.3	2.4.1. Up to 1 year 9)	597.4
1.2.3. Other Euro area residents	950.6	2.4.2. Over 1 and up to 2 years 9)	239.7
1.3. Money market fund shares/units 8)	93.7	2.4.3. Over 2 years	3,802.2
1.4. Holdings of shares/other equity issued by Euro area residents	1,310.7	2.5. Capital and reserves	1,678.8
1.4.1. Monetary Financial Institutions	418.5	2.6. External liabilities	4,531.2
1.4.2. Other Euro area residents	892.2	2.7. Remaining liabilities	2,704.4
1.5. External assets	4,868.9	Total	29,385.8
1.6. Fixed assets	207.5		
1.7. Remaining assets	2,146.0		
Total	29,385.8		

Eurozone credit markets



German mortgage bond market

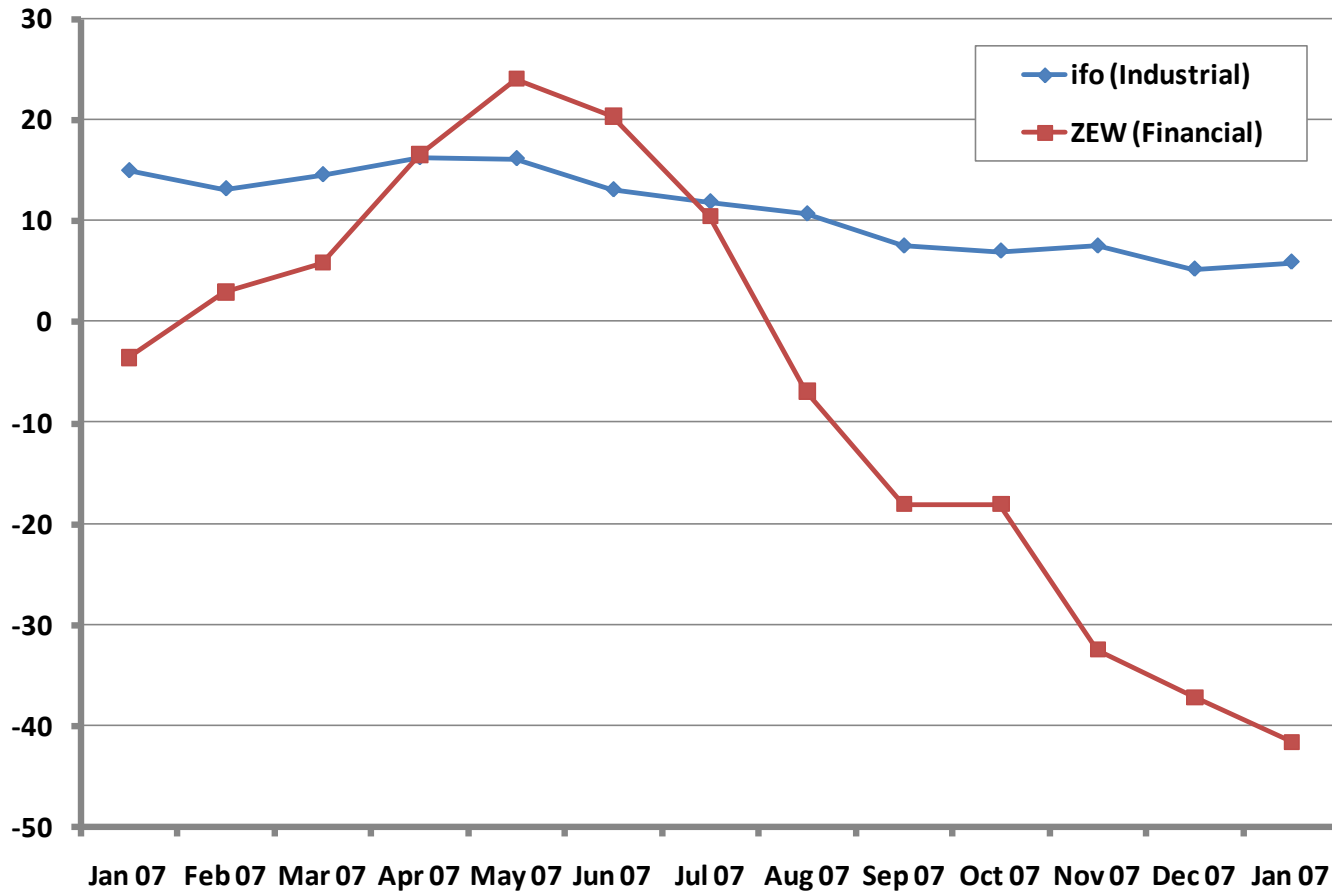


(4) News and expectation formation

- **Financial industry as one of the major news producers**
- **Expectation formation**
 - **Households: consumer sentiment**
 - **Lagging indicator,**
theoretically not convincing for capturing news channel
 - **Companies: business climate (Germany)**
 - **At best: coincidental indicator**
 - **Real sector business climate much more robust than financial sector expectations**

Business climate in Germany

Balances of expansionary answers in %



(5) Additional aspects

- Increase of private savings in the US is welcome in order to reduce the non-sustainable current account deficit
- Rather weak influence of US economy on the Eurozone (growth elasticity between 0,1 and 0,2)
- Asian sovereign funds would have increased their investments in Western companies sooner or later anyway (banking crisis as a good opportunity only)