The Year in Research: Subprime, Credit Crunch, and Core Inflation

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Once again, here's a completely subjective rundown of the most noteworthy academic research that sprung forth from academia in 2008.

1) Subprime All the Time
What we learned, sort of learned, and should have learned about the financial crisis:

Bubble Psychology or Declining Standards?
Two papers took a relatively similar tack to arrive at very different answers about what started the current mess.

The first, by four Fed economists, found that the information available in 2005-06 should have allowed analysts to deduce the presence of the subprime ticking bomb. The reason that didn't happen, the researches argue, is that analysts just didn't think home prices would fall so rapidly. And why didn't they? Bubble psychology of course.

The second paper, from Uday Rajan, Amit Seru, and Vikrant Vig found that even if analysts' models knew exactly how badly home prices would perform in the future, they would have still failed to predict the subprime outcome. The real culprit, they argue, was lax standards induced by securitization. Their evidence:

We analyze data on securitized subprime loans issued in the period 1997-2006 and demonstrate that interest rates on new loans rely increasingly on hard information characteristics - interest rates become increasingly sensitive to a borrower's FICO score and loan-to-value (LTV) ratio and the distribution of interest rates shrinks over time.

The papers aren't as in much disagreement as it might seem. The Fed economists found that while most analysts were able to predict that a drop in home prices would have disastrous effects on mortgage-backed securities, there was one firm that failed to do so: Standard & Poor's. And the model used by the authors of the second paper was based off one created by ... Standard & Poor's.

Still, I don't know if that explains all of the difference between the two papers' results. It could be that, ultimately, analysts trusted S&P's model more than their own, or that a firm's MBS business didn't use their own analysts' models. Research by Efraim Benmelech and Jennifer Dlugosz of Harvard of 3,912 CDO tranches issued by different firms found that the tranches "all seem to conform to the same CDO model." That model being S&P's.

A Central Figure
I was a big fan of Yale and AIG's Gary Gorton highly informative paper arguing that declining lending standards couldn't account for the subprime blowup, but then I read this quote from him in December 2007 at an AIG investor meeting:

"We stopped writing [the CDO] business in late 2005 based on fundamental analysis and based on concerns that the model was not going to be able to handle declining underwriting standards."

Hard to Break Bad Habits
If bubble psychology was even partly responsible for our current woes, can we learn not to repeat the same mistakes?
The results of a study of 100 German money managers isn't promising: Even when the managers were aware of the existence of behavioral biases, they didn't feel it applied to them.

The Credit Crunch Is Real
In the aftermath of Lehman's bankruptcy in September, some Minnesota Fed economists boldly claimed that the credit crunch was in large parts a myth.

But a survey of CFOs by Murillo Campello of the University of Illinois and John Graham and Campbell Harvey of Duke showed that 80 percent of firms with lower credit ratings had to cut back on R&D, employment, and capital spending because of the crunch.

Other work by Harvard's Victoria Ivashina and David Scharfstein found that new lending "declined substantially during the financial crisis across all types of loans."

Short-Sale Bans and Small-Scale Asset Repurchases Don't Work
In response to the Panic of 2008, the government pulled out most of the stops to calm markets including a short-sale ban and the infamous TARP I. New research shows that the first was useless while the second would only work if very large amounts of money were devoted.

The Aftermath for Wall Street
After a decades-long ascent, the financial sector is likely to contract for an extended period, suggests research by NYU's Thomas Philippon, who also shows, to no one's surprise, that bankers had become overpaid.

2) White Guilt
My favorite non-subprime paper this year came from Devin Pope of Wharton and Justin Sydnor of Case Western who found that on the peer-to-peer lending site Prosper.com, a listing with a picture of a black person was 25 to 35 percent less likely to get funded than a listing with a white person with similar a profile. But despite this, risk-adjusted returns on loans to blacks were lower than the average return for all loan, implying that lenders weren't discriminating enough.

3) Global Warming and Growth
Melissa Dell and Benjamin Olken of M.I.T. and Benjamin Jones of Northwestern show:

   First, higher temperatures substantially reduce economic growth in poor countries. Second, higher temperatures appear to reduce growth rates, not just the level of output. Third, higher temperatures have wide-ranging effects, reducing agricultural and industrial output, investment, innovation, and political stability.

4) Counterintuitive Claims

China Helps America's Poor - That was the claim of a controversial paper from University of Chicago economists Christian Broda and John Romalis.

What Resource Curse? - It turns out that being resource rich probably doesn't mean that a country is doomed to totalitarianism, say Stanford's Stephen Haber and Victor Menaldo.

5) If Women Ruled the World
Two papers gave us a glimpse of what that might be like. The first, by Uri Gneezy and John A. List of the University of Chicago and Kenneth Leonard of Columbia, found that in the matrilineal Khasi culture of India, women were more competitive than men, and just as competitive as men from a very male-dominated society. (Other work this year showed that women can become more competitive under affirmative action.)

The second paper, by M. Marit Rehavi of Berkeley, looked for a link between the percentage of women in a state's legislative body and budgetary priorities. Surprisingly, expenditures on health was the only category that increased as the relative power of women grew.

6) Trading on the News
Two different studies showed that algorithmic trading strategies relying on the text of news stories and analyst reports can be profitable.
7) Forensic Economics
More researchers turned to data to uncover potential wrongdoing. NYU's David Yermack found uncanny timing of stock gifts by CEOs to their own family foundations. Meanwhile, M.I.T.'s Mozaffar Khan and Hai Lu of the University of Toronto showed some compelling evidence of significant front-running on Wall Street. (Front running is when brokers execute trades for their own account, or tip-off favored clients like hedge funds, before filling customers' orders.)

8) Core Inflation or Not?
A Philly Fed researcher says headline inflation is a better predictor of future inflation. A DC Fed economist disagrees.

9) Did Fast Food Cause the Obesity Epidemic?
Michael Anderson and David Matsa, economists at UC Berkeley and Northwestern, examined this question and came to the surprising conclusion that, no, there is no correlation between eating out and weight gain.

But another recent study says Anderson and Matsa's finding isn't quite right. Janet Currie of Columbia University and Stefano DellaVigna, Enrico Moretti, and Vikram Pathania of Berkeley focus solely on fast food as opposed to all restaurants, and conclude that "among 9th grade children, the opening of "a new fast food restaurant within a tenth of a mile of a school is associated with a 11 percent increase in the obesity rate in that school. There is no discernible effect at .25 miles and at .5 miles."

10) Odds and Ends
Three more studies worth mentioning:

1. Wal-Mart (WMT) didn't cause the obesity epidemic either.
2. Why does New York City have such relatively few married women with jobs?
3. Priests, just like CEOs, respond to pay incentives.

And that's it. I know, a lot to digest -- but you have all of 2009 to get through it!