Notes on Macroeconomics Reading

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1 Brunnermeier

In *Deciphering the Liquidity and Credit Crunch 2007-2008*, Brunnermeier (2009) states that the increase of delinquent mortgages and the plummeting of housing prices triggered the dry-out of financial liquidity and the high-rocketing of defaults. The long-term economic and social effects brought by this crisis still last even today. To demonstrate what has happened, the author first explains how the traditional banking model transformed to the originate and distribute model and why it is related to the initiation of the financial crisis. Then, he retells the whole story of this financial market turbulence and introduces four mechanisms behind those facts.

A huge amount of bad loans were originated from the classification and the ranking system of different loans. AAA ratings could be very useful for investors to verify the credibility of different financial products. Buyers of those financial derivatives were also protected by credit default swaps. However, the maturity mismatch in the money market funds advocated the strategy of investing in long-term properties and borrowing with short-term paper, which pushed the banking system exposed to funding liquidity risk and led to the significant increase of repurchasing contracts. At the same time, the loosing of the regulation system became the potential risk since more and more banks cooperated intimately with those rating agencies to assure that their tranches just reached the margin of AAA ratings, resulting in the boosting of unqualified credits and the arbitrary distribution of housing loans.

In early 2007, the increase of defaults stroke the investors' confidence about the subprime mortgages. To protect their reputations, ranking agencies started downgrading many tranches, which made people more skeptical about the reliability of financial derivatives they had held. Even though the Federal Reserve endeavored to inject more currency to alleviate the liquidity crunch and save the banking system from the crisis, many macroeconomic variables still indicated that the participants in the financial markets were reluctant to lend money since they were uncertain about the future. The repurchasing agreements, affected by the downgrades, were no longer enforceable and this led to the burst of liquidity bubbles and the shrinking of credit spreads.

Later, the write-downs continued and aggregated amongst major international banks, making the loss in the mortgage market clearer. Many investment banks, such as Bear Stearns and Lehman Brothers, encountered the severe liquidity problems and were hit heavily by this financial crisis. The bankruptcy of Lehman Brothers rippled down many markets, provoking serious economic consequences around the world.

Several mechanisms were revealed in this event. The unbalanced leverage between the long-term assets and short-term paper decreased the funding liquidity and market liquidity, which made borrowing money harder. Also, by this leverage, the risk of bad loans was heavily underestimated on the balance sheets of banking systems, leading to higher future volatility. Regulation from the outside was opaque and hindered by the close relationship with investment banks.

From my perspective, the influence of this financial crisis was not limited in the credit market, but spread to every component of worldwide economy. This article specifically targets on this event and provides economic analysis behind those events. Economic recession, as a part of the business cycle, is required for more studies and researches. Besides, this 2008 financial crisis also implies the importance of the reputation and integrity of ranking agencies and the measure of risks in the banking system.

2 Olson

According to the journal *Distinguished Lecture on Economics in Government: Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor*, Olson (1996) introduces that the difference in national wealth among different nations can be explained by efficient market hypothesis that market is self-efficient since the price can be used to indicate the allocation of resources. Individual rational behaviors will lead to the voluntary employment and profit maximization automatically. Although the function of free market can be easily and clearly demonstrated, the reasons for an obvious income difference between rich and poor countries are still in doubt, and the author tries to illustrate reasons behind the phenomenon in this paper. This research will be helpful for government officials to make public policies in a more rational way.

The per capita income of rich and poor nations differs significantly and there are two possible theories to explain. The first one is the difference of resources such as land, labor, capital and technology. In this case, it is assumed that poor countries have limited resources for the production, so their total output is much less. The second one is the difference of public policies. In this case, it is assumed that poor countries have bad policies to allocate resources in an inefficient or mistaken way and thus lead to the less total output. The author considers almost all factors in production and concludes that economic policies play larger roles in creating national wealth and that is the major reason for the income disparity among different countries.

Except the brand new technology developed recently and protected by laws, basic production knowledge is easy to acquire these days in a low cost. It is easier for poor countries considering that they do not need to spend time and money in researching, so the access to technology is not the main reason for the income disparity. More population does not have to mean less personal utility explained by the contradiction of North-South Model and the real case of Ireland and Great British. By the model, we conclude that the migration will cease after their populations are almost the same and the country with higher population density will be poorer because of the lower output per capita. However, this is not what really happened. In the real world, Great British is richer even though its population density is higher.

Capital turns out to be a strong indicator of how rich and developed a country is because there is a higher opportunity to get higher rewards in richer countries and capital is much easier to move compared with labor. Human capital, including both skills and civic culture, also plays an important role in promoting economic activities. Finally, after several comparisons of economic policies from different geographic areas, the author focuses on the impact of economic policies in creating national wealth. The growth theory indicates that, as long as the economic policies are improved, poor countries can grow faster than rich countries since the potential growth rate for rich countries is bounded.

For the purpose of this research, the author separates different variables and only considers one every time, which is critical to prevent the co-effect of multiple variables. Besides, the cases from the real world are more persuasive and direct than the abstract models and this is important for keynote speaking papers.

From my perspective, this paper strengthens the importance of good public policies, which is closely related to the overall economic performance. Also, capital density will be a good measurement to evaluate the economic performance.

3 Friedman

In the Chapter Two of his book *Capitalism and Freedom*, Friedman (1962) states that the use of the government channel is inevitable but should be restrained in a limited scope since the market, the invisible hand, can allocate resources effectively and efficiently in most cases without any manipulation. In the meantime, he summarizes several areas that cannot be handled by the market and require regulations from the government. The government needs to make rules and deal with monopoly as well as neighborhood effect.

The first and the most fundamental function of the government is to make rules. The legal environment of business and specific rules for commercial activities should be created by the government. This function should not be viewed as the restriction of freedom since the absolute freedom is impossible and one's freedom might conflict with others'. The government, in this case, should be an arbitrator in dealing with the possible disputes during the commercial activities. It is also the government's responsibility to protect property rights and ensure a relatively stable monetary system.

The second function of government is to deal with monopoly and neighborhood effect caused by negative externality which cannot be resolved by the market. Monopoly is possible when the market determines it is better to have only one producer. However, the monopoly tends to be inefficient and reluctant to the innovation, leading to the slowdown of the increase of productivity. The neighborhood effect is shown in economy when there is a negative externality. Externality is defined as the byproduct of economic activities which will not be considered in the profit-making process. For example, pollution is not what the factory wants to produce but a danger for people near that factory. The role of the government here is to ensure that negative externality produced by some individuals will not harm other individuals and can be dealt with properly.

At the end of this chapter, the author mentions the responsibility corresponding to the rights of freedom. Freedom is not permissible to madmen considering the neighborhood effect and is limited to children until they grow up and are mature enough to take their own responsibilities.

This article provides the insights for several roles of government and why they are important. Free market is undoubtedly required to achieve the self-efficiency of economy, but the government is also irreplaceable when we encounter the limitation of the market. The creation and maintenance of legal environment facilitate business and guarantee the ownership of legitimate property, providing incentives for people to create wealth. Also, the regulation enforces firms to be more socially concerned and aware of their adverse byproducts during the production and profit-making.

References

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