

Animal Spirits, Financial Literacy, and the Housing Crisis

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Dallas Fed Conference



Polycymaking
Insights 
 from
Behavioral
Economics 

Edited by
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Lorenz Goette,
and Stephan Meier

Outline

1 Behavioral Economics and the Housing Crisis

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- 2 Supplementary Slides: “Economics” and “Behavioral Economics”

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 - Regulation

Thaler and Sunstein on the Housing Crisis

A main cause of the mortgage crisis is that borrowers did not understand the terms of their loans. Even those who tried to read the fine print felt their eyes glazing over, especially after their mortgage broker assured them they had an amazing deal.

Richard Thaler and Cass Sunstein
“Human Frailty Caused the Crisis”
Financial Times
November 11, 2008

Thaler and Sunstein on Policy Prescriptions

Far more important [than concentrating on today's crisis], it is crucial to design policies that will prevent similar problems in the future. Behavioral economics provides specific suggestions not just for mortgages, but also for credit cards, cellphone plans, prescription drugs, and student loans. The basic idea is that for complex financial instruments, the government should strive for what might be called "simplified transparency."

Richard Thaler and Cass Sunstein
"Economic Policy for Humans"
Boston Globe
April 17, 2008
(insertion added)

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 - ... is very widely shared,
 - ... concerns the ability to understand house prices,
 - ... and is closely related to the concept of “animal spirits”



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New York, NY
(between 5th & Madison Avenues)



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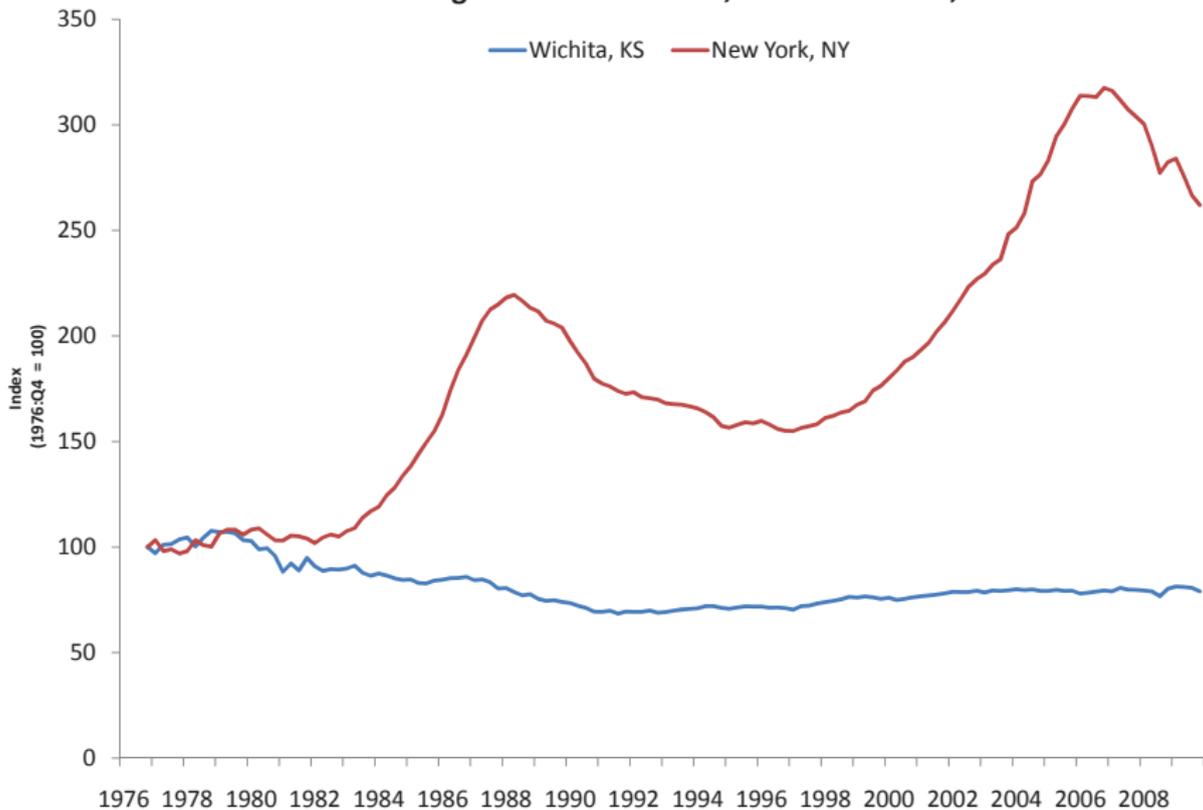
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Real Housing Prices in New York, NY and Wichita, KS



Source: Federal Housing Finance Authority; Bureau of Labor Statistics

Wichita Amenities

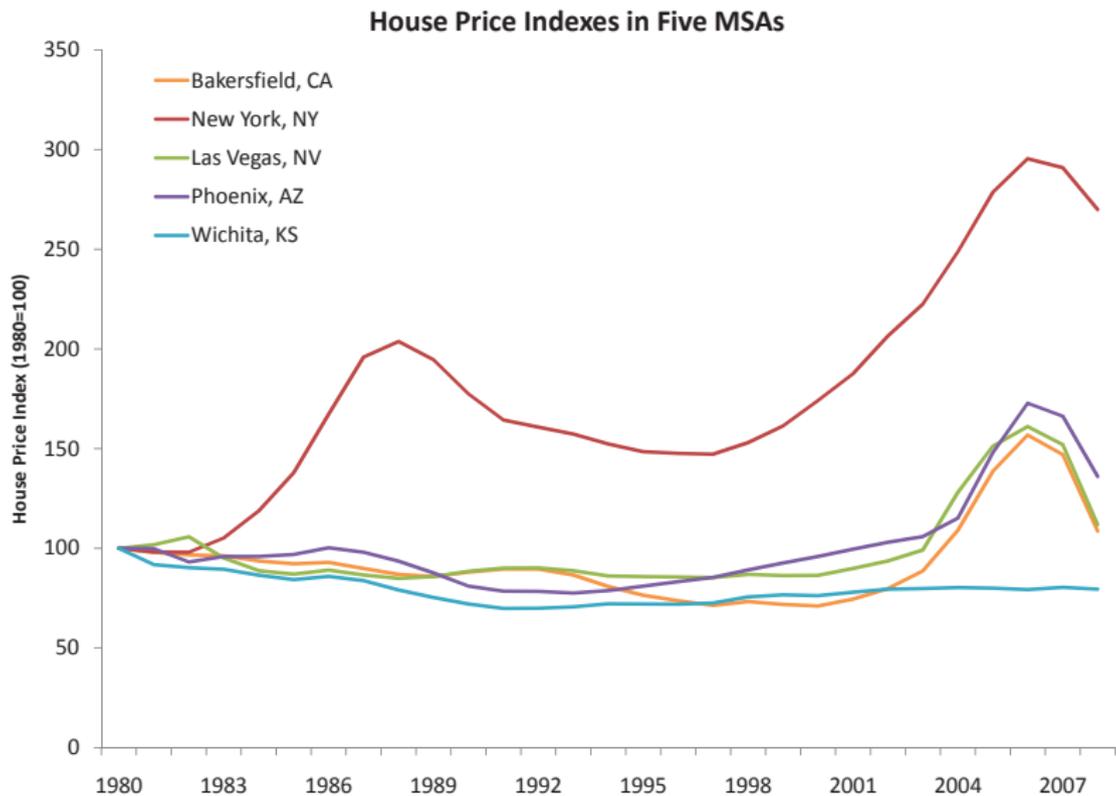


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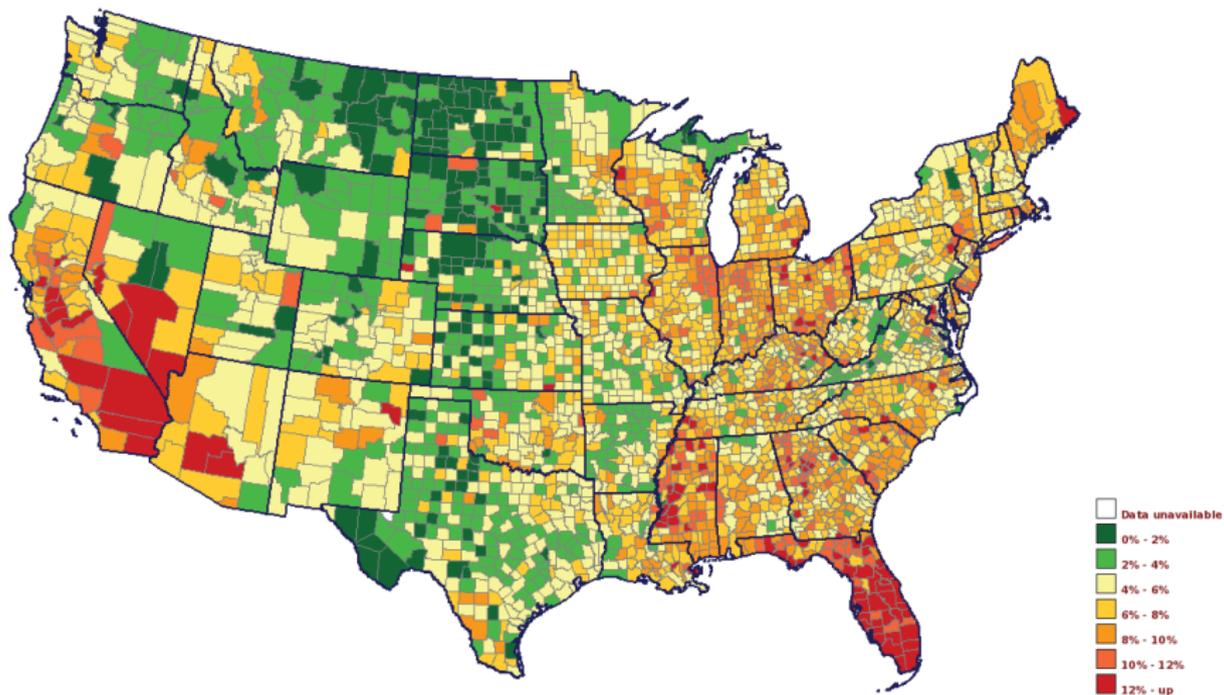
New York Amenities





Location of Mortgage Distress

Mortgages 90+ days delinquent or in foreclosure, by county



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 - We do have models of how asset prices should behave, given “rational” expectations
 - But “irrationally” optimistic expectations can give rise to either multiple equilibria (good) or asset bubbles (bad)

Famous Bubbles in History



Tulipmania
(1630s)



South Sea Bubble
(1710s)



Florida Real Estate
(1920s)

Famous Bubbles in Recent History



Beanie Babies
(mid-1990s)



Internet Stocks
(late 1990s)



U.S. Housing Market
(early 2000s)

Financial Illiteracy

We were on the March 22 [2007] call with Fitch regarding the subprime securitization market's difficulties. In their talk, they were highly confident regarding their models and their ratings. My associate asked several questions. "What are the key drivers of your models?" They responded, FICO scores and home-price appreciation (HPA) of low single-digit or mid-single-digit [rates], as HPA has been for the past 50 years.

Financial Illiteracy (con't)

My associate then asked, “What if HPA was flat for an extended period of time?” They responded that their model would start to break down. He then asked, “What if HPA were to decline 1% to 2% for an extended period of time?” They responded that their models would break down completely.

Robert L. Rodriguez, CFA
“Absence of Fear”
CFA Society of Chicago Speech
June 28, 2007

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- Likely to be a tough problem to solve, given numerous examples of poor self-control in many non-economic aspects of life

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 - *Homo Economicus* would not have given a dime to Bernie Madoff

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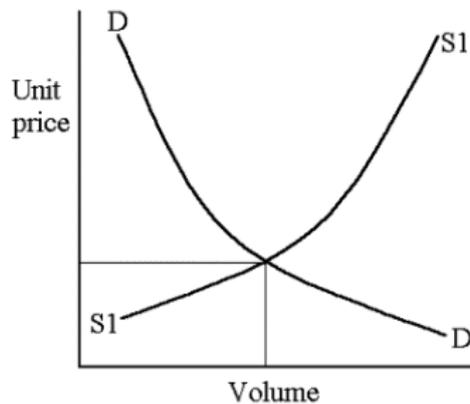
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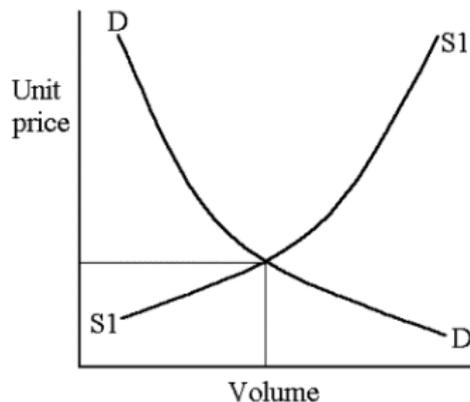
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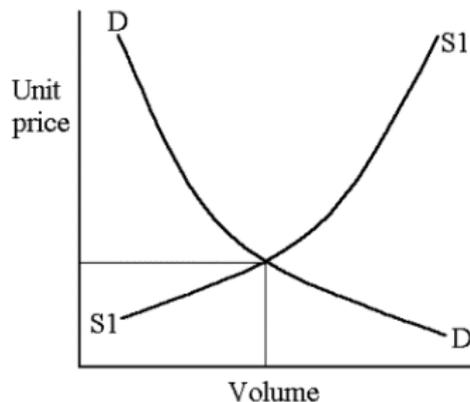


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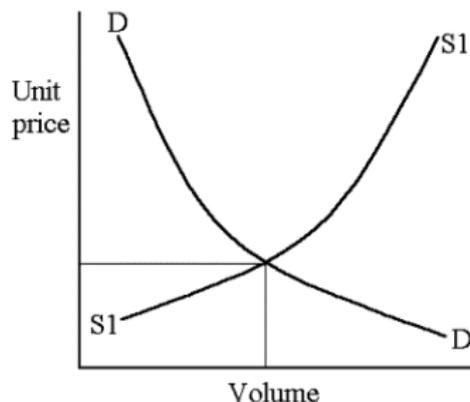
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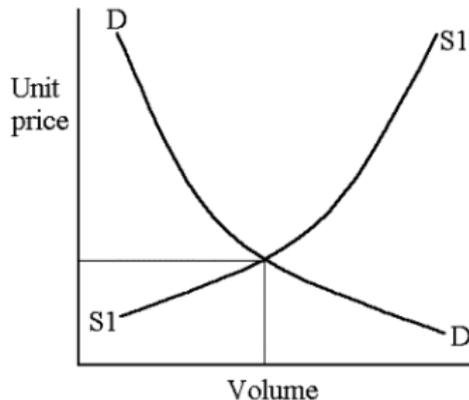
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- Equilibrium: Unique price results

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FREAKONOMICS

**A ROGUE ECONOMIST EXPLORES
THE HIDDEN SIDE OF EVERYTHING**

"Prepare to be dazzled."

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More Sex Is Safer Sex

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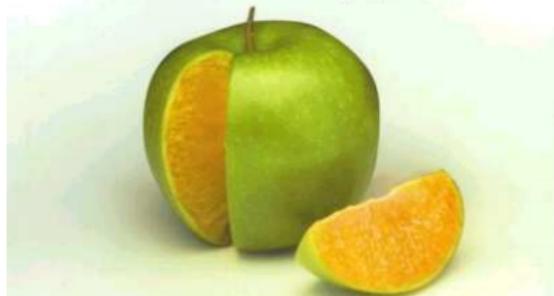
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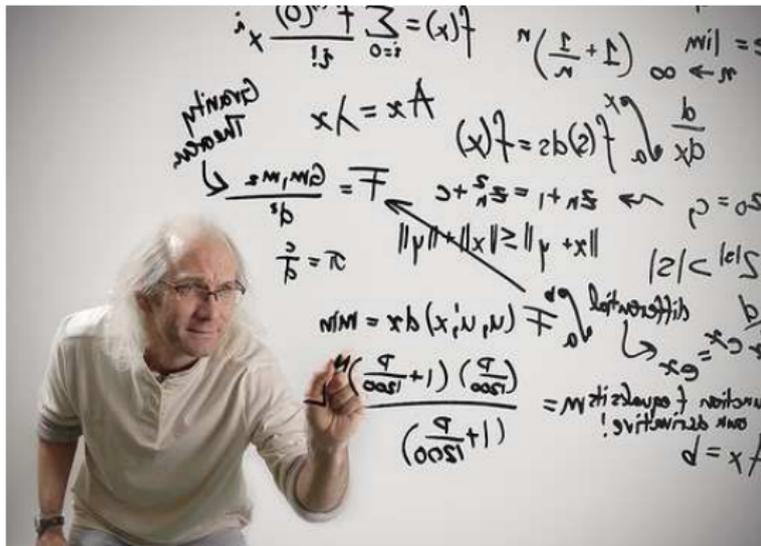
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- Example of consumer choice: $\frac{Price_A}{Price_B} = \frac{MU_A}{MU_B}$
- Before long: *Homo Economicus*!



Homo Economicus ("Economic Man") described



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