Research sheds new light on the Great Recession

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It's no secret that a housing bubble kicked off the financial crisis that began in 2007, rippling through institutions caught holding subprime mortgages. But a fresh look suggests much of the lingering damage was caused by the forced sale of corporate bonds at below-market prices, starting a chain reaction that cascaded through the supply chain.

"Spreading the Fire: Investment and Product Market Effects of Corporate Bond Fire Sales," by University of Houston finance professor Praveen Kumar and Hadiye Aslan, assistant professor of finance at Georgia State University, was presented at the American Finance Association Conference.

The research already has drawn attention from advocates for additional reform of the nation's financial markets, and Kumar predicts regulating the financial system will become an issue in the 2016 presidential race.

"The enormity of the financial crisis has been so huge," he said. "The problem is to try to figure out why."

For many people, he notes, the Great Depression of the 1930s is history; their frame of reference is the recession that began in 2007 and continues to affect global economies. Where most previous recessions were short-lived and followed by robust recoveries, this one still lingers.

The question, Kumar said, was why the housing bubble spread to the broader economy, sparking corporate cutbacks and job losses.

"There is a widespread view that financial market shocks were transmitted to the real sector - the 'Wall Street sinking the Main Street' syndrome," he and Aslan wrote. "In particular, shocks in the asset-backed commercial paper market led to substantial losses on the balance sheets of banks, forcing them to sell assets in 'fire sales,' contract their lending firms, and force the economy into a prolonged recession. This narrative appears incomplete, however, because higher credit quality firms tend to finance investments from issuing corporate bonds."

They determined that institutional holders of corporate bonds - primarily insurance companies and mutual fund firms - had also acquired risky mortgage securities. Unable to sell those, the companies had to sell corporate bonds issued by financially healthy companies in order to maintain liquidity, a "fire sale" that meant selling the bonds for less than they were worth. With previously issued corporate bonds on the market at cut-rate prices, even strong companies were unable to issue additional bonds to finance capital expenditures, and the resulting stalemate spread to those companies' suppliers and customers.

"Even for very good companies in the U.S., there was pressure because the insurance companies and mutual fund companies had to sell those bonds," Kumar said.

He and Aslan found that capital expenditures of affected firms dropped by 14.5 percent, while research and development dropped by 17.2 percent.

They said their work is among the first to examine the economic spillover effects of corporate bond fire sales on the capital investment and product market performance of the exposed firms, along with its impact on those firms' customers and suppliers.

Americans for Financial Reform (AFR), a nonpartisan coalition formed

after the financial crisis, cited the paper in its comments on proposed regulations of asset management activities. The study, AFR wrote, "provides powerful evidence that bond fire sales by mutual funds during the financial crisis created direct economic harm to real economy companies, reducing investment and profitability over a period of years."

Kumar expects to see more discussion of the financial markets over the next year. "This highlights how integrated the financial markets are with the rest of the economy," he said. "One financial market sneezes, and the rest of the economy catches pneumonia. This goes far beyond Wall Street."

Provided by University of Houston

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