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Economic Outlook

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Fine in 2009 (Not So Great in 2008)

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The good news about the problems in the financial sector and the larger economy in the United States emanating from the persistent drop in house prices is that they will eventually end, and the underlying resiliency of the U.S. economy will reemerge. The bad news about these problems is that they are going to continue for some time and get worse before they improve. Efforts to address them so far have been ineffective because they have been aimed at containing a subprime credit crisis, not at containing a rapidly spreading prime-credit, solvency crisis that is leading the U.S. economy into recession.

In early December, the Treasury introduced its subprime mortgage support plan, the Federal Reserve's Open Market Committee cut the federal funds and discount rates by 25 basis points each, and the Fed also announced that it was creating a special new lending facility designed to distribute liquidity more broadly and effectively. Nevertheless, signs of problems in the financial sector and the real economy persisted. Shares of Citigroup, the nation's largest bank, fell by 11 percent during the week ending December 14. Shares of mortgage lenders Countrywide and Washington Mutual fell by 15 and 20 percent respectively during the same week. All of these price drops came on top of already substantial falls since August. Even shares of the redoubtable Goldman Sachs dropped by 3.5 percent in one day after Goldman's disappointing earnings report on December 18. Goldman's shares, perhaps the best in the financial sector, are down about 15 percent from their late October high.

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News from the real economy was not much better. The worst news came with the announcement on December 14 of a sharp 0.8 percent monthly rise (4.3 percent year-over-year) in the Consumer Price Index (CPI) and a 0.3 percent rise in the core CPI, bringing the year-over-year core inflation rate to 2.3 percent. The larger-than-expected increase in the core CPI carries with it the troubling implication that higher food and energy prices are beginning to spill over into the prices of other goods and services. This outcome is troubling for two reasons. Higher inflation cuts the real purchasing power of wages and income, whose growth is slowing. A more immediate problem is tied to the need for the Fed to hold back on interest rate cuts for fear of pushing core inflation above its desired ceiling of 2 percent.

The important questions to ask as we move into 2008 with a slowing economy and continued pressure in the financial sector are these: Why have efforts to address the credit problems thus far failed? What effective actions might be available in the future? And what might the ultimate implications be for the financial sector and real economic growth during this difficult period?

Treasury Efforts

The Treasury has undertaken two efforts to support the financial sector, one aimed at lenders and another aimed at borrowers. The first effort, known as the "Super SIV," was directed at helping banks to organize a $100 billion fund to purchase off-balance-sheet holdings of special investment vehicles (SIV) that were having difficulty obtaining financing in the commercial paper market.

Details of the plan were never clearly specified, but the idea was to support the prices of assets contained in SIVs. The plan was announced in mid-October at the same time Citigroup released its first disappointing estimate of third-quarter earnings. At that time, Citigroup's shares were priced at around $47. Subsequently, Citigroup reported further downward revisions to its earnings, dismissed its chairman and CEO, Chuck Prince, and announced a new CEO, Vikram Pandit.

During the week ending December 14, Citigroup, which had been the primary supporter of the SIV program, reversed itself and announced it would bring $49 billion of SIV assets back onto its balance sheet, thereby largely abandoning the Treasury's first initiative aimed at supporting banks. The Treasury-encouraged effort to shore up the prices of banks' off-balance-sheet items was a failure because it was a departure from transparency for banks. The value of those assets was largely indeterminate and falling, tied as they were to persistently falling house prices. Citigroup's shares closed on December 14 at $30.70 per share, down more than 35 percent from their level in mid-October, when the Super SIV was announced.

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On December 6, the Treasury announced a plan to help a purported 1.2 million subprime borrowers avoid foreclosure tied to rate resets, typically from about 7 percent up to 11 percent or higher as specified in the terms of their subprime "teaser" mortgages. Subprime problems, which have existed since 2005, are extreme and are about to get worse. The same day, the *Wall Street Journal*'s front-page coverage of the subprime plan included another story on a "victimized" subprime borrower.[1] The story featured a California housekeeper who obtained, in 2005, a $713,000 undocumented subprime mortgage with the help of her church's minister, whose day job was as a mortgage broker. Apparently God wanted the housekeeper to have a house. Now, Alan Greenspan, based on his December 10 suggestion for payments to distressed subprime borrowers, implies that the government should send her a check. Greenspan and his colleagues ought to have prohibited such mortgage abuses under the authority granted to the Fed by the Home Ownership Equity and Protection Act.[2]

Earlier, while Greenspan was extolling the virtues of adjustable-rate mortgages and then claiming no housing bubble existed or could be identified, the subprime "victim" featured in the *Wall Street Journal* obtained a primary mortgage for $570,000 and a second "piggyback" loan for $142,600 to cover the down payment (no cash up front here). At the teaser rate of 7.15 percent (higher for the piggyback), the monthly payments, excluding the insurance and property tax, started at about $5,000—almost the combined monthly income of the housekeeper and her husband. They abandoned the house after three weeks of occupancy, and the house went into foreclosure in late 2005.

The Treasury's subprime mortgage support plan aims to avoid rate resets on subprime mortgages that are due to accelerate in 2008 and are tied to mortgages originated in 2006. The Treasury plan is well intentioned. However, it advocates the abrogation of contracts tied to subprime mortgages. While aiding distressed borrowers, many of whom were purchasing their first homes, is a worthy goal, abrogating mortgage contracts can only impair the value of such contracts that are already held by mortgage lenders worldwide. The result will be a further decline in mortgage-backed securities, whose value is already falling under the weight of persistently declining home prices. Beyond that, new mortgage lending will be further impaired if the precedent of government cancellation of mortgage contract terms is firmly established.

The best thing that can be said about the Treasury plan is that it will probably end up affecting relatively few households—perhaps two hundred thousand to three hundred thousand—far below the 1.2 million initially advertised by Treasury officials. Even that modest number may be further reduced by technical problems related to implementing the cap on subprime mortgage rates and to legal actions against mortgage servicers who have the difficult task of delivering the news about reduced mortgage payments to investors who recently purchased subprime mortgages.

Federal Reserve Efforts

The Federal Reserve is struggling in a two-front war. It is simultaneously battling growing problems in the financial sector and the related problem of a weakening economy in which some inflation pressures have begun to emerge, raising an ominous threat of a modest bout of

stagflation. On December 11, the Fed announced rate cuts of 25 basis points in both the fed funds and discount rate. In its accompanying statement, the Fed wanly noted that its actions "should help promote moderate growth over time" when "combined with the policy actions [75 basis points of fed funds cuts] taken earlier." Stocks promptly dropped by more than 2.5 percent, while interest rates fell by 25 basis points, and the dollar fell by nearly 1 percent against the yen. These adjustments were very large given that markets had expected the 25-basis-point cuts.

Hours after the rate cut announcements, through a leak to CNBC's evening talk show on financial markets, the Fed provided a hint that it was holding a little more candy up its sleeve. The next morning, on December 12, as had been hinted via CNBC, it was breathlessly revealed that the Fed, along with central banks in England, Europe, and Canada—with good wishes from the ever-passive Bank of Japan—was establishing measures to enhance liquidity in the banking system. The Fed's "Term Auction Facility" (TAF) aims initially to supply $40 billion in short-term liquidity directly to all banks (even small regional ones) through a stigma-free auction of term funding, based on a wide set of collateral. The rates will be slightly below the Fed's discount rate and will be offered for periods up to thirty days, the same as for loans offered at the discount window.

The TAF constitutes a Fed experiment to improve its ability to manage liquidity flows to the banking system. It does not mean—contrary to the suggestion on December 12 by the *Financial Times*' excitable Martin Wolf—that "the helicopters start to drop money." The reserves injected through the TAF are temporary, although they probably will be sustained through subsequent operations. But they will be offset by smaller temporary funding operations conducted largely through money center banks. The TAF funds will be offered to all banks, but the aggregate level of liquidity in the banking system will have to be maintained at a level consistent with the target rate on fed funds—currently 4.25 percent.

After the Treasury's subprime effort, Fed rate cuts, and the creation of a new Fed funding facility (the TAF), the hope and expectation was that financial firms and homebuilders' fortunes might be expected to improve and that this improvement would be reflected in their stock prices. Such was not the case. The Treasury's efforts were judged to be ad hoc, market distorting, and insufficient, while the Fed's efforts, aimed at liquidity problems, failed to address more serious solvency problems tied to the rising probability of home value losses exceeding $3 trillion.

No Easy Fix

The underlying cause of the problems in the financial sector is a persistent fall in house prices. That drop in house prices has removed a large part of the elastic credit and wealth appreciation that helped to support consumption during the period of zero savings since the last recession in 2001. Many have contended that it is incorrect to suggest that a housing recession is a necessary condition for a U.S. recession because this time is different. It is true that, normally, a tightening Fed leads to a weakening housing sector, which is part of a recession, not the cause of a recession. But this time it is not different. The Fed raised interest rates by 400 basis points between June 2004 and June 2006. House prices leveled off in 2005 and began to fall late in 2006. During late 2006 and early 2007, there were repeated episodes of weakness in the housing sector, each of which was deemed the end of the adjustment that was supposed to be confined to subprime-based lending. However, house prices continued to fall and by November were falling at a 5 percent year-over-year rate, with large enough inventories of unsold homes to suggest that prices would continue to fall at least until 2009, bringing the total reduction in house prices to around 15 percent.

The U.S. housing stock is worth about $23 trillion, so a 15 percent drop in house prices represents a wealth erasure of $3.45 trillion over a period of about two years. That figure represents about a quarter of annual GDP or about 12.5 percent of GDP per year for two years. The total equity capital of U.S. banks, brokers, and finance companies, most of whom are exposed to losses and to levered credit markets tied to falling real estate prices, is barely $1 trillion. While their share of total cumulative real estate losses will be only a fraction of the potential $3.45 trillion in losses that would result from a 15 percent drop in house prices, their share of the losses will certainly impair their capital and thereby their lending ability to a substantial extent.

The efforts by the Treasury and the Fed thus far to contain the problems tied to the collapse of the U.S. housing bubble have failed simply because they have been inadequate. That said, they have probably slowed the onset of the problems and, to some extent, reduced the ultimate size of losses that are likely to be experienced. The obvious solution to the problems tied to the collapse of the housing bubble is to arrest and then reverse the largest drop in house prices since the Great Depression.

The political complexity of the "solution" to the growing problems facing the U.S. financial sector and

the U.S. economy—they grow as house prices continue to fall—is its least attractive aspect. House prices ballooned in the first place because of the massive subsidies that already exist to encourage home-ownership, including full deductibility of mortgage interest expense for most homeowners; favorable tax treatment of home sales; full deductibility of state and local taxes on real estate; preferential lending facilities subsidized by multiple government agencies, including Fannie Mae, Ginnie Mae, the Federal Home Loan Bank System, and the Federal Housing Administration; and others too numerous to mention. Beyond that, a period of very low (1 percent) short-term interest rates administered by the Fed was followed by huge capital inflows and a highly elastic credit system that boosted house prices into bubble territory. By failing to disrupt the house price bubble from expanding until it exploded, it is now unwise to contemplate further incentives to home buying, which might only reinflate the bubble.

So the Fed and Washington's struggling policymakers are left with the unsatisfying option of containing the damage from the housing bust, the initial phase of which has been under discussion here. Given the sharp deceleration of U.S. growth, coupled with troubling signs of higher core inflation, the next step toward containing the damage will be to address the fear that arises as the U.S. recession exacerbates the housing downturn and threatens more acute economic distress among American households. When the sacred benefits of home ownership are threatened during the coming U.S. election year, expect a combination of an immense outpouring of blame directed at all quarters, including the Bush administration, Congress, and the Federal Reserve, in addition to greedy subprime mortgage lenders, hedge funds, and the ultimate bugaboo—foreigners.

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Unfortunately, the record shows that while election years are high on rhetoric in the face of difficult problems, such as the collapse of the U.S. housing bubble, they are low on solutions. Rather, it probably makes more sense to look for a large housing bailout sometime in 2009 that will entail the creation of an agency that looks like the Resolution Finance Corporation, which helped to end the Savings and Loan Crisis over two decades ago. Basically, the compromised loans tied to depreciated housing are auctioned to the highest bidder, many of whom will obtain good bargains. To the extent that auction prices seriously impair the balance sheets of financial intermediaries, taxpayers will likely be asked to fill the hole, probably to the tune of some $500 or $600 billion. While the Fed will appropriately resist the pressure for inflation, part of the solution will probably be several years of inflation that runs closer to 3 percent than the desired 1.5 to 2 percent range. Perhaps the pain of that exercise will cause the Federal Reserve to re-examine the proposition that you cannot identify a bubble while it is in the making and therefore should not try to prevent one from inflating. By early 2005, it was clear that the latest housing bubble was well underway as the sad case of the California housekeeper so painfully illustrates. The Fed could have and should have stepped in to slow things down with efforts targeted at the excessive real estate–related lending by financial intermediaries.

What Would You Do?

It is fair to ask what steps might move us toward a path leading to recovery from the credit and other problems that have plagued the economy since the summer. The problems are spreading. Kenneth Lewis, the far-sighted head of Bank of America, which sidestepped much of the subprime mess and saw it coming well before others, has warned that the persistent drop in home prices is hurting prime borrowers. How can the spreading damage be contained?

In the subprime sector, rapidly rising foreclosures can lead to dumping more homes on the market, thereby exacerbating already falling home prices and boosting credit problems for all borrowers. A simple plan to mitigate subprime losses would allow distressed subprime borrowers to become renters of properties they occupy. The lender could negotiate a rent that might approximate current mortgage payments and take title to the property

while offering the borrower/renter the option to buy the property back at a mutually agreed price in the future. That plan—far from perfect as it is—would avoid a forced sale of the house and a total write-down of its value by the lender.

The Fed should cut the fed funds rate until the Treasury-security yield curve steepens further, say to a 200-basis-point spread between short-term rates and ten-year notes. That will help bank income statements and stimulate some additional spending. During December, the spread between yields on ten-year Treasury notes and the fed funds rate—a measure of how aggressively the Fed is easing—was about zero, its average level at the start of the last nine recessions. On average, after the Fed starts to respond to a recession, the fed funds rate is pushed down by 200 basis points relative to yields on ten-year notes. That would mean a cut to 2.25 percent from today's 4.25 percent fed funds rate, provided that ten-year yields hold steady. Markets already expect a 100-basis-point cut by October 2008 with little encouragement from the Fed. Negative growth numbers emerging in the first half of 2008 will push the Fed to exceed currently anticipated interest rate cuts. If ten-year yields fall further, below the current 4 percent level, more cuts in fed funds would be needed. If they rise because inflation expectations increase—the worst outcome—the Fed may have to cut less or let its 2 percent core-inflation target slip.

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Another big policy push should be directed toward establishing transparency in the market for mortgages and derivative securities. This will require a move toward auctions of such assets where accurate market pricing of complex securities can be established in order to remove the uncertainty in the financial sector that is impeding the free flow of funds. The securities were created and sold on the expectation of rising house prices, so their value will be reduced by an amount that reflects losses on real estate that probably will total over $3 trillion. In the process of auctioning such assets, any emerging insolvency of financial institutions should not be allowed to compromise depositors, just as depositors in Savings and Loans were protected by the Resolution Trust Fund, at a cost of about $150 billion to taxpayers after the S&L collapse of the late 1980s. This time, the cost—even excluding shareholders—could run to $500 billion.

If all of these measures are undertaken, things will be fine in 2009. This year, however, may not be so great.

Notes

1. Jonathan Karp and Miriam Jordan, "How the Subprime Mess Hit Poor Immigrant Groups," *Wall Street Journal*, December 6, 2007.

2. Ed Andrews, "Fed and Regulators Shrugged as the Subprime Crisis Spread," *New York Times*, December 18, 2007.