

## What Lies Beyond the Credit Crunch? Part II

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Peter J. Wallison  
Introduction

The last time our AEI economists met to discuss the future of the credit crunch and the U.S. economy was in December 2007. At that conference, there was sharp disagreement about whether the U.S.—as a result of the housing meltdown, the credit crunch, and other factors—was headed for a deep recession, a shallow recession, or merely a slowdown for a quarter or two.

The data presented at the conference showed a serious breakdown in trading in the credit markets and major losses impending in the housing market. These factors could suggest a serious recession is on the way, but at that point there was no clear evidence of a recession during the fourth quarter of 2007. The Dow, which opened at 13,339 that morning, was down from its high of 14,000 in October, but certainly not signaling a serious recession.

All the participants in the December conference thought that their predictions would be proved correct when several months of additional data were available. So we scheduled this conference to see whether any positions have changed, and whether things have become any clearer to our AEI economists.

From the perspective of a non-economist, things still look pretty cloudy on the recession question. The Dow is about 500 points lower than it was in December, but it has been rising recently. Friday's Wall Street Journal noted this with the headline: "Dow rises 85.73 Points as Some Investors Shed Fear." Since much of the buying was of financial stocks—banks and brokers—the fear that investors were shedding was probably fear that the credit crunch would deepen. If in fact the credit markets are returning to normal, that would take one reason for a deep recession off the table. In this connection, it is useful to note that 3-month Libor is 40% below its 52 week high.

The attached chart (Figure 1) shows that the spread of mortgage backed securities over the 10-year Treasury has been declining substantially since the Fed's moves in conjunction with the bailout of Bear Stearns in March, but it is still 50% higher than it was last April and 10% higher than it was in December. And the very high jumbo mortgage rates haven't come down at all since December.

Nevertheless, it does look as though we are beginning to deal with the credit market fallout from the subprime meltdown. Attached is a table (Figure 2) showing the recapitalization that is going on among the banks. This indicates that we are not headed for a Japan problem. The recapitalizations will enable banks to begin lending faster,

without concern that their loans will further reduce their regulatory capital. Sustained bank lending will shorten and reduce the severity of any recession.

In your materials is an article I wrote last month, arguing that the real question of the subprime meltdown was whether the taxpayers or the shareholders would pay for the losses. At the moment, it looks very much as though it is the shareholders, as it should be. The issue, as I saw it, was whether the banks would recapitalize—diluting their shareholders—or hold back in the hope that the government would pick up the losses. The bank recapitalizations, probably forced by supervisory jawboning, are answering that question. Nevertheless, there are indications that some banks will not be able to recapitalize and will fail. That will produce a market shock that could send the market reeling again. Things are still pretty fragile.

At the same time, the votes last week in the House Financial Services Committee significantly narrowed the number of subprime or other borrowers who are likely to be eligible for bailouts by the government. What this means, I think, is that the decline in home prices will be sharper but will end sooner. Take your choice. The important thing, in my view, is that the losses are recognized by the financial intermediaries and appropriate actions taken. That appears to be happening.

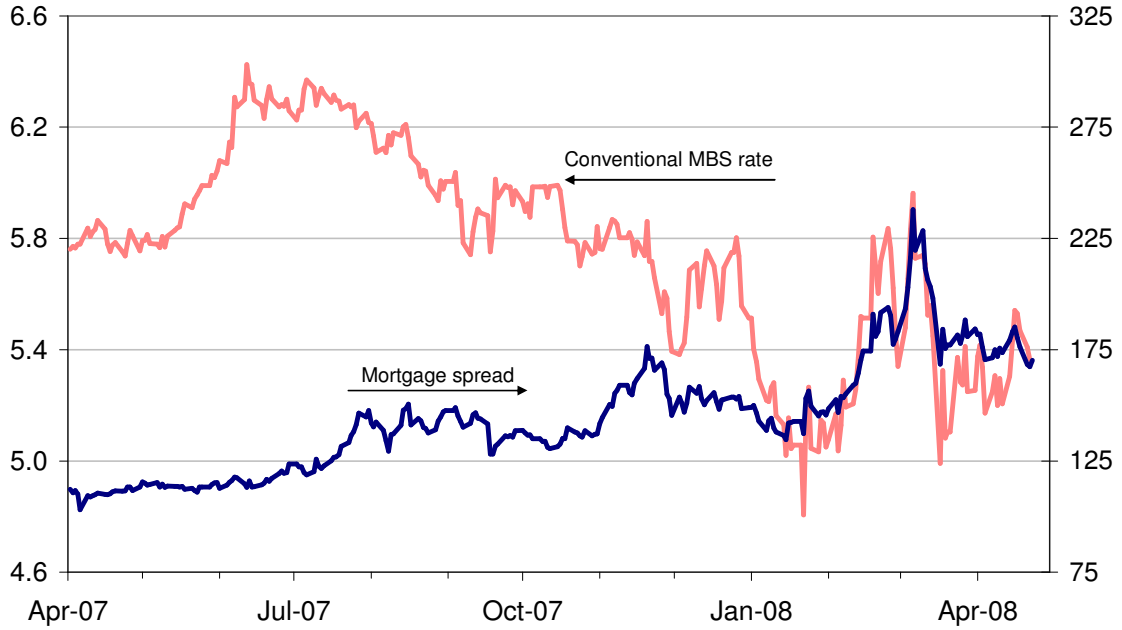
Finally, a few weeks ago, the Business Roundtable published the attached table (Figure 3) summarizing the views of its CEO members about the year ahead. The best summary of this summary is: the future looks better than today. The CEOs don't see a major decline in their future.

So, overall, there is modest improvement, but the key issues—how far will home prices fall and whether there will be failures among banks and other intermediaries—are still unknowns. Just right for commentary by our panel of economists.

**Figure 1**

**Progress In Narrowing The Spread, Which Is The Target Of Fed Liquidity Moves, Has Slowed**

30Yr Conventional MBS rate and its spread over 10Yr Treasury



**Figure 2**

**Worldwide Bank Asset Writedowns, Credit Losses,  
and Capital Raised**  
in billions of dollars

	<u>Write downs</u>	<u>Credit Losses</u>	<u>Total</u>	<u>Bank Capital Raised</u>
Jan 15				<b>59.4</b>
Jan 22	107	26	133	
Jan 31	120	26	146	
Feb 1				<b>84</b>
Feb 22	135.2	26.4	161.6	
Feb 25				<b>105</b>
Feb 29	154.5	26.4	180.9	
Mar 7	162.4	25.8	188.2	
Mar 14	168.8	25.8	194.6	
Mar 26	182.4	25.8	208.2	
Apr 1	206	25.8	231.8	
Apr 2				<b>135.8</b>
Apr 10	216	29.4	245.3	
Apr 16				<b>162.5</b>
Apr 21	247.6	42.3	289.9	
Apr 24			308.7	<b>212.2</b>

Source: Bloomberg.

**Figure 3**

	Increase	No Change	Decrease
1. How do you expect your company's sales to change in the next six months?	70%	21%	9%
2. How do you expect your company's U.S. capital spending to change in the next six months?	35%	50%	15%
3. How do you expect your company's U.S. employment to change in the next six months?	30%	48%	22%