

### Credit Crunch III

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The last two times we met I said that a deep recession was unlikely, and that several quarters of sideways motion or a shallow recession were much more likely. I argued that the capital crunch that began over a year ago was being mitigated by large amounts of capital raising by banks and by aggressive Fed and Treasury policy actions, that housing price declines from the mid-2007 peak were being exaggerated by the flawed Case-Shiller index, and that empirical evidence indicates that the effects of foreclosures on house prices going forward would be mild, in spite of the looming increases in foreclosures.

It is noteworthy that the sideways motion of the economy I predicted has occurred over the past several months. The economy has been remarkably resilient and has so far weathered the credit crunch quite nicely. The US may have entered a recession already, but even if it has (as I believe it has), so far it is a mild one. It is also noteworthy that banks have raised much more capital since our last meeting – according to Bloomberg, \$434 billion as of three days ago. More than \$40 billion was raised this month alone, partly in support of stabilizing acquisitions of weak banks. Furthermore, lending in commercial banks has continued to grow. These patterns are a sharp contrast to the 1930s or the 1980s.

Most importantly, policy makers provided liquidity, and more than liquidity, to shore up banks. Whatever one thinks of those actions, one thing is clear: Most of the prior looming risk that significant financial institutions might fail has been resolved one way or another. Weak large banks are pretty much gone. The assets of Lehman, Bear, Merrill, Wamu, and Wachovia have been acquired or are in the process of being acquired. Fannie and Freddie are in conservatorship (and supporting growth in the supply of mortgage credit). Morgan and Goldman survived their mid-September bear runs and raised significant capital.

Although Goldman and Morgan were briefly at risk on September 17 and 18, that risk has passed, especially in light of their capital raising and the likely passage of the rescue bill.

The concentration of the risk of loan losses in the few remaining big banks also means that we have a much more accurate picture of the distribution of loan losses among the largest five financial institutions (Goldman, Morgan, JP Morgan, Citi, and Bank of America). None is currently at risk of failing. Total worldwide losses on subprime and Alt-A will likely be no more than \$500 billion and probably less than that. Add on other losses and one cannot reasonably get the total of all writedowns above \$1 trillion. Given that some of that is in the protected hands of Fannie and Freddie (who own \$1 trillion of the \$3 trillion subprime and Alt-A claims), and that banks' retained earnings and capital offerings have raised huge amounts of capital, so long as the current financial panic that began on September 17 subsides, which now seems quite likely in light of impending legislation, banks will acquire additional capital easily (through a combination of private and public actions), and so I believe that we will see a mild (but possibly protracted) recession going forward, but not a deep one.

There is little doubt that the Treasury is about to recapitalize and liquefy US banks to ensure that inflated credit spreads decline and that credit grows at a steady (albeit slow) pace. The immediate panic of the past 15 days is largely the result of the fallout from Lehman's failure. Although the effects of this continue to be felt, they are dissipating.

House prices will continue to decline, but only slightly, in the face of rising foreclosures, and this is not going to exert a very large effect on consumption. Employment is the bigger concern for consumption. It seems very likely that consumption and investment will fall over the next several months. US Labor markets, manufacturing, and durable goods are all pointing in the direction of recession now, and the recession is clearly going global in Europe, Asia, and elsewhere. But so long as credit markets stabilize, there is still reason to believe that the recession probably will not be too bad.