*American Enterprise Institute for Public Policy Research*

Economic Outlook

November 2007

# One Fix Too Many

## By John H. Makin

Just as Wall Street was celebrating the presumed end of the latest financial crisis by pushing stocks to record highs, proclaiming continued strong earnings growth, and continuing to recite the mantra "slowdown, but no recession," Treasury Secretary Henry Paulson provided a vivid reminder that the housing and mortgage crisis is not over. On Monday, October 15, while Citibank was reporting that compared with last year's results its third-quarter earnings had fallen by 57 percent, the Treasury's "super-SIV" plan was revealed. It seems that the Goldman Sachs alumni at Treasury—Paulson and his under secretary for domestic finance, Robert Steel—had become concerned that the off-balance-sheet special investment vehicles (SIVs) held by commercial banks might not be financeable. That would mean that not enough investors could be found to provide the short-term financing necessary to sustain SIVs, the repositories of hard-to-value securitized mortgages that continue to plague bank balance sheets.

Why, wondered investors, if the mortgage crisis had been successfully contained, would the Treasury be stepping out of its usual role to initiate a discussion among banks about financing SIVs? Depository institutions such as Citibank, Bank of America, and JPMorgan are the Federal Reserve's bailiwick, and if they have problems that need addressing and that constitute systemic risk, it is the Fed's role to address those problems. At best, the Treasury's initiative seems a gratuitous bailout effort, while, at worst, it seems an indication that the banks' balance sheet problems tied to the housing collapse were worse than had been supposed.

John H. Makin (jmakin@aei.org) is a visiting scholar at AEI.

Meanwhile, the Federal Reserve was keeping its distance from the Treasury initiative, saying only that it was being kept informed.

### Markets Respond to Bad News

By the end of the week, on Friday, October 19, the twentieth anniversary of the 1987 stock market crash, after a week of gradually falling stock prices, the U.S. stock market fell more than 2.5 percent while interest rates and the dollar fell sharply—all signals that investors were taking the recession story more seriously than they had been before the super-SIV plan was introduced. Of course they had some help from other factors. On the Monday evening after the super-SIV announcement, Fed chairman Ben Bernanke appeared before the Economic Club of New York to present a somber picture of the downturn in the housing market and the difficulties associated with pricing securities whose value is tied to the hope and expectation that house prices would rise instead of fall. On Wednesday, October 17, the release of September data on housing starts and permits revealed a virtual collapse of housing construction, with a drop of 56 percent in starts and 43 percent in permits, both on a three-month annualized basis. When builders are dumping houses with the help of 10 and 20 percent price reductions, they are hardly inclined to step up housing starts.

The bad news continued throughout the week as earnings disappointments spread in the financial and manufacturing sectors. Broadly, estimates for year-over-year earnings growth of S&P 500 companies went from about 6 percent on August 17 to –0.1 percent on October 12. Wall Street's hype

about the durability of earnings growth was undercut by third-quarter earnings reports. Adding to the likelihood that a recession was underway or impending, data released on Thursday, October 18, showed a sharp rise in initial jobless claims. One of the bulwarks of the "slowdown only" camp has been the claim that employment and wages will hold up enough to keep consumption growing. If employment growth weakens further, a recession goes from a possibility to a virtual certainty.

Alan Greenspan chimed in on Friday, October 19, to say that the Treasury's super-SIV plan—which had since evolved to a $75 billion "master liquidity enhancement conduit" (MLEC) proposed by Citigroup, Bank of America, JPMorgan, and Wachovia to take on the assets of troubled investments—ran the risk of further undermining already brittle confidence in besieged credit markets. Greenspan went on to point out that the MLEC plan was not comparable to the New York Federal Reserve's rescue of Long-Term Capital Management, thereby underscoring the Fed's coolness toward the Treasury's super-SIV initiative. Clearly, at a time when the current Fed chairman, Ben Bernanke, voiced concern as housing data deteriorated at an accelerating pace and hopes for modest employment growth were being dashed, it was not wise for the Treasury to remind investors that all was not well with bank balance sheets.

> Every housing downturn since World War II has resulted in a U.S. recession. Given that this housing downturn is more intense than most, there is no reason to suppose that a U.S. recession in 2008 is not at hand.

## Housing Bust Still Means Recession

The bottom line on the housing and mortgage crisis has not changed since housing prices started to soften in 2006 and have since started to fall nationally on a year-over-year basis for the first time since the Great Depression. The late stages of the housing boom were fueled by financial innovations that required the securitization of mortgages into financial instruments whose value depended on the continued rise in house prices. The futility of pretending that this problem has been alleviated by a 50 basis-point rate reduction from the Fed was underscored by the Treasury's ill-timed attempt to address ongoing bank balance sheet problems. For optimists, the Treasury's effort was a jarring reminder that the problem was not over, as they had assumed it was. For the pessimists, the Treasury's initiative was an occasion to reiterate how intractable the problem of valuing derivative mortgage securities has become. How, they asked, can a group of banks put together a fund among themselves to purchase mortgage assets whose value remains indeterminate?

The SIVs are items that the banks placed off their balance sheets in order to avoid regulatory restrictions on bank investments in risky assets. The problem is that the banks will be obliged to further tighten credit when they take those risky assets back on to their balance sheets unless they can arrange financing for them in the commercial paper market. But participants in the commercial paper market, aware of the extreme difficulty of evaluating the assets in the SIVs, are unwilling to roll over the financing for those vehicles. The Treasury's plan essentially suggests that the banks should put together a fund to purchase only the best of the assets in the SIVs in order to somehow restore confidence. But the best of the SIV assets are not the problem. Beyond that, why should the banks need the help of the Treasury to construct a fund to purchase attractive assets?

The basic problem is much simpler to understand than the esoterica attached to the valuation of SIVs or Treasury intervention in facilitating their financing by banks that already own them. The housing bubble has collapsed and will continue to deflate. Even without the existence of exotic and hard-to-value mortgage derivative securities, every housing downturn since World War II has resulted in a U.S. recession. Given that this housing downturn is more intense than most and has involved greater compromise of the balance sheets of major banks, there is no reason to suppose that a U.S. recession in 2008 is not at hand. The only way to avoid it would be a massive easing stimulus by the Fed that resulted in a reversal of the drop in house prices—a virtually impossible undertaking—which would surely entail the return of the serious inflation that the Fed is pledged to avoid.

The rest of what has unfolded since the financial market panic in August has been an exercise in concerted denial. The arguments have taken various forms: There will not be a recession because employment growth will hold up and households will continue to boost consumption. Corporate earnings will hold up well and thereby support the stock market. The drop in the dollar will stimulate exports enough to cause the economy to avoid

recession. In the week leading up to the twentieth anniversary of the 1987 stock market crash, these hopes were undercut and fears of a recession returned with a vengeance. As I have already noted, stock prices fell, but the dollar and interest rates also fell—all in anticipation of weaker earnings and more aggressive Fed rate cuts to try to cushion the onset of a recession. Through the rest of 2007, stock prices and the outlook for the economy will, no doubt, continue to oscillate, but they will do so around a declining trend line.

## Macroeconomic Laissez-Faire

The rush back into risky trades after the Fed's policy moves in August and September, coupled with the Treasury's proposed super-SIV intervention in the credit markets, has brought us to a moment of truth concerning the outlook for the U.S. economy. At issue is a cost-benefit analysis of government intervention to avoid recessions. The extreme degree of risk-taking behavior after 2003 that resulted in a widely noted underpricing of risk created a housing bubble in the United States. The housing bubble raises questions: Should the economy be allowed to operate in an environment in which lenders make undocumented loans to borrowers on the basis of virtually no information regarding the borrowers' ability to repay the loans? Is it adequate for the orderly operation of credit markets for lenders to make undocumented loans only because they merely originate the loans and then resell them into packages of securities, many of which have been labeled triple-A or low-risk by credit rating agencies compensated by those packaging the securities in the first place?

To put it more bluntly, we have discovered that widespread underpricing of risk has resulted in a housing bubble the unwinding of which will cause a U.S. recession. In the name of avoiding a recession, should the financial decision-makers involved in creating the bubble be protected?

Ben Stein, an optimistic economist with an admirably broad view of the world, which has included regular appearances on TV quiz shows and hilarious displays of droll humor in movies, said it well. While suggesting that the U.S. economy probably is not in serious trouble, he notes that "some extremely worrisome things have happened and are now being revealed and worse are yet to come." These are the problems that I have discussed over the past several months that likely will lead to a U.S. recession.

What I suggest here is that a U.S. recession may be necessary to push financial decision-makers back toward the appropriate valuation of risk. Stein is more direct:

> The vicious, cruel truth is that some very greedy, selfish, and yes, stupid men made fortunes on deals that were economically and/or ethically wrong. (Why else hide them off balance sheets or abroad?) They got immense fees, stunning paychecks, and the inheritance of maharajahs. . . . The ones at the top aren't fired, or if they are fired are fired very rich. (Never mind that silly mouth music from Citigroup about "the year of no excuses.") . . . Despite what looks to me like a breathless lack of disclosure, I have not seen any lawsuits by the Securities and Exchange Commission against any of these big money center princes or principalities—not to mention criminal investigations from other law enforcement authorities.

A U.S. recession may be necessary to push financial decision-makers back toward the appropriate valuation of risk.

Instead of the investigations that Stein suggests, we have seen an effort by the treasury secretary and the under secretary for domestic finance to bail out the banks as a response to the bursting of the housing bubble. In so doing, they have cynically suggested that they are really just thinking about the unfortunate American homeowners, especially those victimized by subprime lenders who might lose their homes. Many subprime borrowers are already in bankruptcy proceedings, as a glance at any newspaper will show.

The issue of a post-bubble American recession attributable to inadequate risk analysis by private-sector decision-makers is really an issue of macroeconomic laissez-faire. Economists are quick to argue that government intervention on a micro basis can distort resource allocation. So too can excessive government intervention on a macro basis. If decision-makers conclude that when excessive risks are undertaken, either the Fed or the Treasury will step in if necessary to keep the economy on an even keel, then such intervention will lead to too much risk-taking. Excessive risk-taking will result in more volatile growth and inflation, which, as we have learned over the past twenty-five years, is to be avoided

if long-run stable growth of output and productivity is to be encouraged.

I am suggesting here that the cost of avoiding recession after the biggest housing bubble in American history has burst is too high. It will involve rewards to those who took excessive risks that will only result in more underpricing of risk in the future, and therefore larger bubbles and, ultimately, a more unstable economy that underperforms expectations.

I am not suggesting that the Fed should stand idly by as economic growth slows while inflation remains stable or falls further. The Fed's decision to reduce the fed funds rate by 50 basis points on September 18 was tied to an observation that the economy was slowing rapidly and that the disruptions in financial markets would exacerbate that slowdown. An aggressive move was necessary to initiate preemption of a self-reinforcing, dangerous, and dynamically unstable downturn whereby a housing mortgage crisis slows the economy; a slower economy intensifies the housing mortgage crisis; and the economy, in turn, slows still further. To avoid that outcome, the Federal Reserve will undoubtedly be reducing interest rates more rapidly in coming months, probably down to 3 percent by the middle of next year.

The cost of avoiding recession after the biggest housing bubble in American history has burst is too high. It will involve rewards to those who took excessive risks that will only result in more underpricing of risk in the future, and therefore larger bubbles and, ultimately, a more unstable economy.

The Federal Reserve should continue to keep its distance from Secretary Paulson's super-SIV proposal. Citibank, the major beneficiary of a superfund bailout, is a depository institution and therefore the direct responsibility of the Federal Reserve and not the Treasury. The super-SIV proposal, as already noted, appeared on the very day that Citibank announced a sharp 57 percent drop in its third-quarter earnings and during a week when Bank of America and Wachovia also reported very weak earnings. Clearly, the Fed shares former chairman Greenspan's view that the SIV problem is not akin to the Long-Term Capital Management meltdown in which it intervened in October 1998. Perhaps the criticism at the time regarding the moral hazard problem entailed by the Fed's intervention, even at that point, has left a mark on the Fed's thinking.

## Recession Beats Alternatives

At the end of the day, the problem facing the U.S. economy—a collapse of a housing bubble with attendant damage to overall growth—is acute but not chronic. The way to avoid a recession—having the Fed print money and push house prices back up—is not a viable option. The Treasury plan is inappropriate because it rewards problematic undervaluation of risk by the heads of major banks, and it is unworkable because any sale of assets to a superfund will involve pricing them at realistic (much lower than par value) levels. The holders of derivative securities are anxious to avoid that outcome and so, ultimately, will not move forward with the superfund plan.

The positive economic aspect of the U.S. housing bubble collapse is that it will lead to a recession. As I have stressed, every housing sector downturn since World War II, most of which have been less intense than the current downturn, has done just that. The normative aspect of the analysis is that given the circumstances, a recession is the most desirable outcome. To repeat, avoiding it would involve so much government intervention and so much reinflation by the Fed that risk-taking would be encouraged even further, resulting in an even larger bubble and a larger subsequent recession.

The route to sustainable growth is not continued bailouts for bankers and financial innovators who have contrived ways to undervalue risk. Japanese bank regulators demonstrated that by allowing banks to hide toxic waste on their balance sheets during Japan's "lost decade" of the 1990s. If discouraging such behavior entails a recession, then it is clear that risk underpricing has become all too widespread. The same is true if avoiding a recession means still more risk-taking, higher inflation, or both. If the Federal Reserve continues to moderate the economic slowdown tied to credit problems with appropriate—non-inflationary—interest rate cuts, the economy will return to a viable, stable, long-run growth path like the one that has generated an unprecedented period of prosperity during the last twenty-five years.