

What Lies Beyond the Credit Crunch?  
Five AEI Economists Assess the Present and the Future of the Financial Markets

Introduction  
Peter J. Wallison  
American Enterprise Institute  
December 17, 2007

In trying to assess the meaning and long term effects of the current turmoil in the financial markets, two questions seem to stand out. The first is whether what's going on in the financial markets is just a financial market problem—with no major adverse effect on the real economy—and the second is whether there was anything that could have been done to stop this train wreck from happening.

This conference will focus on the first of these questions—where this is all going and what can or should be done about it. The discussion today is particularly well-timed. Yesterday's *New York Times* had a mini-debate on the question of whether a recession was on the way, and the President is giving a speech on the subject today.

We will hear today from five distinguished AEI economists. Charles Calomiris will deliver a paper that considers the economic evidence on whether the current credit problems will lead to a recession. Kevin Hassett, Des Lachman, John Makin and Vince Reinhart will respond to Charlie's views with their own.

Are we dealing with a problem that is limited to the financial markets, or will it cause a recession in the real economy? To be sure, the theory that a recession is inevitable is well-founded. Housing prices are falling fast. This will produce a huge loss of personal wealth, and that might cause people to reduce their consumption of goods and services and to increase savings. Enough of that and a recession *is* certain. In addition, losses at banks will cause a tightening of lending standards, reducing the amount of credit available to consumers and thus cutting back their ability to spend. Finally, problems in the asset-backed securities market will mean a rise in credit card rates and perhaps a tightening of credit there, too, with the same negative result for the economy. And anyway, past history shows that recessions almost always follow close upon large-scale housing price declines.

But the evidence of an impending recession is ambiguous at this point.

Employers are still adding jobs. There was robust growth in the third quarter, which included the beginning of the housing price collapse. The stock market, although volatile, is well above where it was in a year ago when the economy looked rosy. It's certainly not forecasting a recession. The old joke about the stock market is that it predicted six of the last three recessions. The point of the joke is that the stock market is always skittish and tends to overreact. In the current case, however, despite the jitters, there is a lot of buying when prices decline.

Asset-backed commercial paper—the securities that are in market disfavor and the principal source of bank and other losses—are not trading normally, of course, but rates have come down substantially since their August highs. Nonfinancial commercial paper is trading

normally, and well below its 52 week high. Car loan rates are at fifty-two-week lows and home equity loans are only a few basis points above their fifty-two-week lows. If there were really a credit shortage that might cause a recession, or a fear among lenders of an impending recession, one would expect to see pricing for car loans and home equity loans that reflects substantially greater risk.

Then, there is the question of what we could have done to prevent the current turmoil in the financial markets. As tough as it is to determine where the credit crunch is leading, it is even tougher to look back and say with confidence that there was some action that we could have taken to prevent the collapse of risk-taking that occurred in early August of this year.

In an article in the *Wall Street Journal* last week, Alan Greenspan made two points in arguing that he and the Fed were not responsible for the subprime debt problem. First, he contended that the very low interest rates in 2003 were necessary to ward off deflation, and second that there is no way for central banks to deflate asset bubbles while they are underway.

“After more than a half-century observing numerous price bubbles evolve and deflate,” he wrote, “I have reluctantly concluded that bubbles cannot be safely defused by monetary policy or other policy initiatives before the speculative fever breaks on its own. There was clearly little the world’s central banks could do to temper this most recent surge in human euphoria, in some ways reminiscent of the Dutch Tulip craze of the 17<sup>th</sup> century and South Sea Bubble of the 18<sup>th</sup> century.” He might well have also cited the dot-com boom of the late 20<sup>th</sup> century.

It is important to recognize that Greenspan is talking about the Fed’s monetary authority. The Fed’s other role as a bank regulator is a lot more difficult to excuse. Once again, regulation has failed, but that doesn’t mean that Congress will not try to impose more regulation.

They certainly will. Regulation is one of the few government endeavors that gets more power the more it fails. Despite its self-serving character, the Greenspan analysis strikes me as correct. Asset bubbles are linked to human nature—our inbred tendency to believe that whatever is going on at a particular time will continue indefinitely, even though we know this can’t really be true. As Herbert Stein of AEI once said, “If things can’t continue, they will stop.”

But if we can’t stop bubbles from developing are we doomed to endless cycles of boom and bust, just when we thought we knew how to tame the business cycle through monetary and fiscal policy? That seems excessively pessimistic, but within a single decade we have witnessed two sectors of our economy blossom into bubbles and then quickly deflate, wiping out substantial amounts of wealth.

Nevertheless, it’s important to remember that both these bubbles were the result of major changes in investor outlook brought on by changes in technology. The dot-com bubble was a creature of the sudden emergence of the Internet. The housing bubble—which occurred in all developed countries—was likely to have been brought on by the enormous growth of world-wide savings that resulted when hundreds of millions of people in Asia and Eastern Europe began to earn better than subsistence wages and their earnings outstripped their ability or desire to consume. All that saving caused a hunt for yield and a decline in risk premiums.

Thus, the optimistic view would be that the dot-com and housing bubbles are one-off events. Not only won't they be repeated for the same assets in the future, but we are not doomed to suffer asset bubble after asset bubble after all.

But having said all that, what should we do *now*? Most of the moves by the Fed and the other central banks have not appreciably changed the reluctance of the world's major banks to lend to one another. Credit markets are still frozen. Should we worry about this? Will it lead to a major recession? Can a major recession be prevented by government or central bank policy at this point?

And what is that policy? These are questions for our distinguished AEI panel.