

Washington's Dangerous Policy Delusion

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A dangerous myth is taking hold in Washington. It is the idea that the Federal Reserve's interest rate cuts, together with the recently approved fiscal stimulus package, will be sufficient to keep the U.S. recession short and mild. The gaining currency of this notion threatens to delay those additional policy measures so sorely needed to address the United States' most severe housing market and credit market crisis in the post-war period.

Over the past few months, official Washington has finally emerged from denial about the gravity of the economic situation. Alan Greenspan, the former Federal Reserve Chairman, is now describing the credit crisis as the most wrenching in the past sixty years. For its part, the Federal Reserve has invoked powers last used in the 1930s as part of its Bear Stearns' rescue program. Meanwhile, in Congressional testimony last week, Ben Bernanke, the present Fed Chairman, has finally acknowledged that the U.S. economy could very well contract in the first half of this year.

Encouraging as their greater sense of realism might be, Treasury Secretary Paulson and Chairman Ben Bernanke are both now peddling the line that the policy measures taken to date will more than likely be sufficient to turn the U.S. economy around by the second half of the year. In particular, they seem to believe that the 300 basis point cut in the federal funds rate since last August, coupled with the recently enacted U.S. \$168 billion fiscal stimulus package, will be sufficient to more than offset the contractionary impact of the ongoing housing and credit market crises as well as of the recent spike in international oil prices.

It is certainly true that the reduction in the federal funds rate from 5¼ percent last August to 2¼ percent today has been the most aggressive such cut in decades. However, as Lyle Gramley, a former Federal Reserve Governor correctly notes, over the same period, long-term government bond rates have not declined by nearly as much, while interest rate spreads on private sector borrowing have blown out.

The net upshot of these market developments is that the economically relevant rates at which both households and corporations borrow today are no lower than they were in August 2007 when the present credit crisis began. To compound matters, over this period, there has been a marked tightening in credit market conditions as the troubled U.S. banking sector has been cutting back on risk, while a pronounced process of de-leveraging is in full train in the non-bank financial sector.

It would also appear that the recently approved fiscal package will to a large degree be negated by very much higher international oil prices. For since last August, international oil prices have spiked from around U.S. \$75 a barrel to over U.S. \$100 barrel today. If maintained, this spike in oil prices will over the course of the year approximately offset the boost to household consumption that might be expected from the fiscal package's U.S. \$100 billion household income tax rebate.

At the heart of today's credit crunch is the continued weakening in the U.S. housing market, which is both reducing household wealth and compounding losses in the financial system. Over the past year, home prices at the national level have declined by 10 percent, while in the latest quarter they were declining at an annual rate of around 20 percent. These declines have already wiped out around U.S. \$2.5 trillion in household wealth thereby contributing to a plunge in consumer confidence.

There is every indication that home prices will continue to fall by at least a further 10 to 15 percent in 2008. After all, mortgage lending conditions have tightened abruptly, the housing market is presently characterized by an excess of 900,000 units of unsold housing inventories, and a sharply rising rate of foreclosures is increasing supply in an already saturated market.

In addressing the present credit crunch, both the Federal Reserve and the U.S. Treasury are making the cardinal mistake of treating the problem as one of liquidity rather than as one of solvency. This would appear to be all the more surprising given that credit conditions today are no better than they were at the start of the crisis some eight months ago. It is also surprising in light of the fact that the International Monetary Fund is now estimating that total financial losses from bad lending could at the end of the day total around U.S. \$1 trillion, which is a multiple of the losses that the banks have recognized to date.

There can be no doubting that housing is the major asset in U.S. households' balance sheets while mortgage lending is a major item for the U.S. financial system. As such, stabilizing the housing market would appear to be a necessary condition for breaking the present vicious cycle between a weakening economy and a deteriorating financial system. The longer policymakers fail to squarely face up to this issue, the longer and deeper the recession is likely to be.

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