

# What Lies Beyond the Credit Crunch?

## Part II

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American Enterprise Institute

# The U.S. Economic Outlook Has Darkened

- Alan Greenspan now characterizes the credit crisis as the most wrenching in the post-war period, while Paul Volcker talks of “the mother of all crises”.
- The Federal Reserve has had to resort to instruments not used since the 1930s.
- A bail out of Bear Stearns had to be orchestrated.
- Mr. Bernanke now concedes that the U.S. economy could contract in the first half of 2008.
- Professor Marty Feldstein of the NBER warns of a severe recession.
- Employment declined by around 230,000 jobs in the first quarter of 2008

# A Confluence of Negative Shocks Still Impact the U.S. Economy

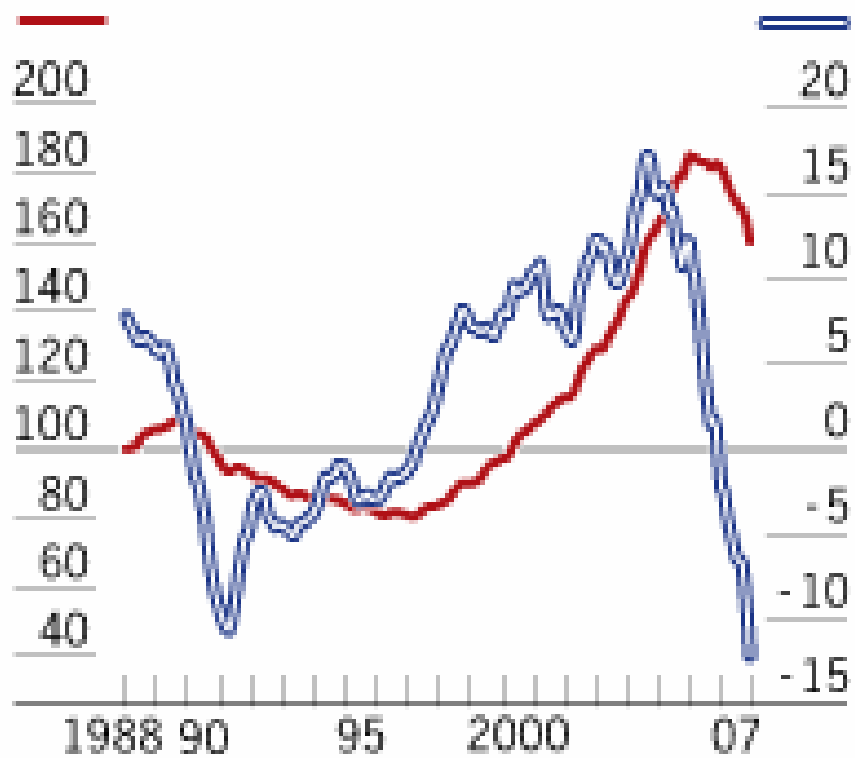
- The housing bust threatens to be by far the most severe in the post-war period.
- The credit crunch shows little sign of abating.
- International oil prices remain at elevated levels.
- The decline in equity prices to date has reduced household wealth by around U.S. \$2 trillion.

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## US real house prices

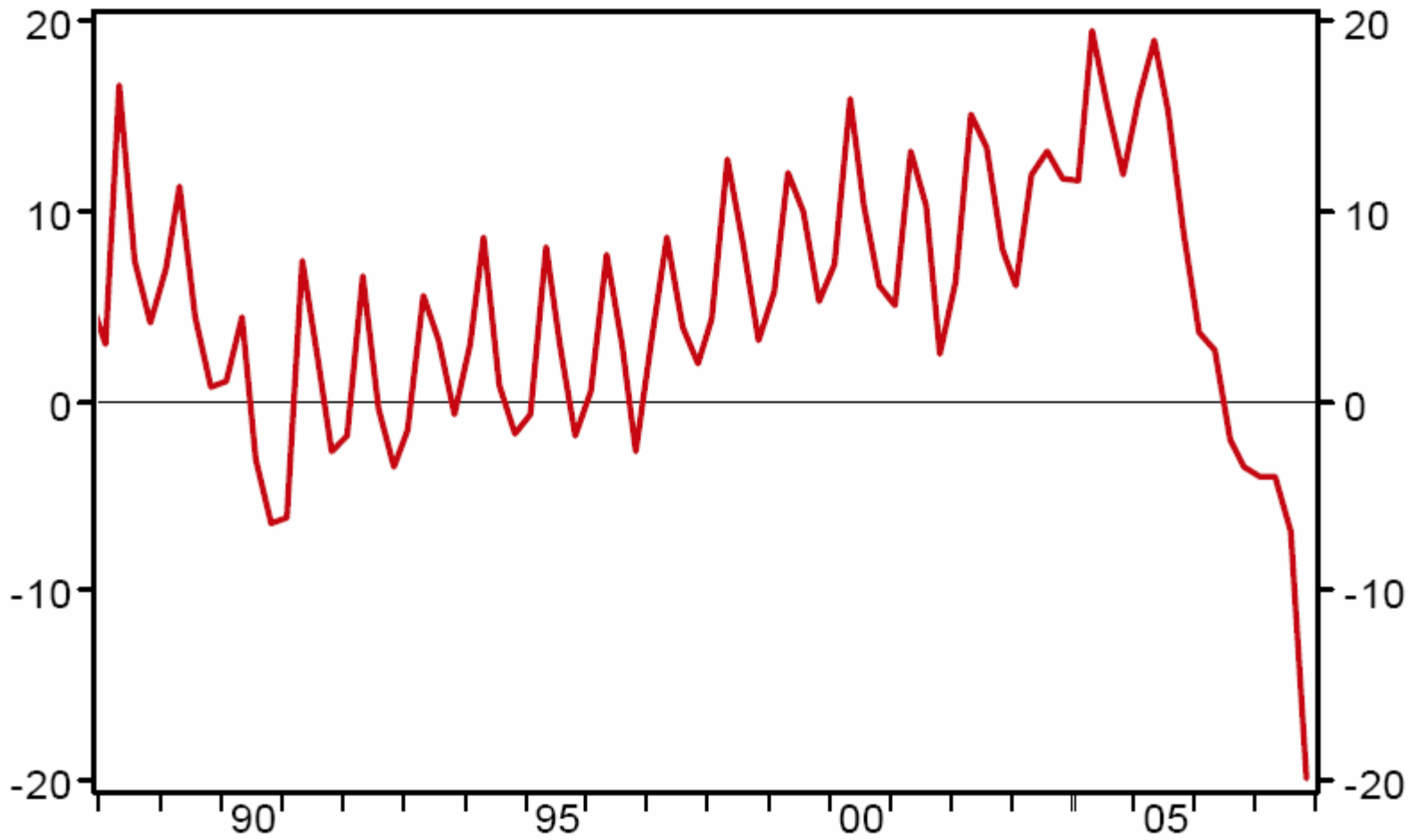
Case-Shiller 10-city composite, deflated by CPI

Annual % change

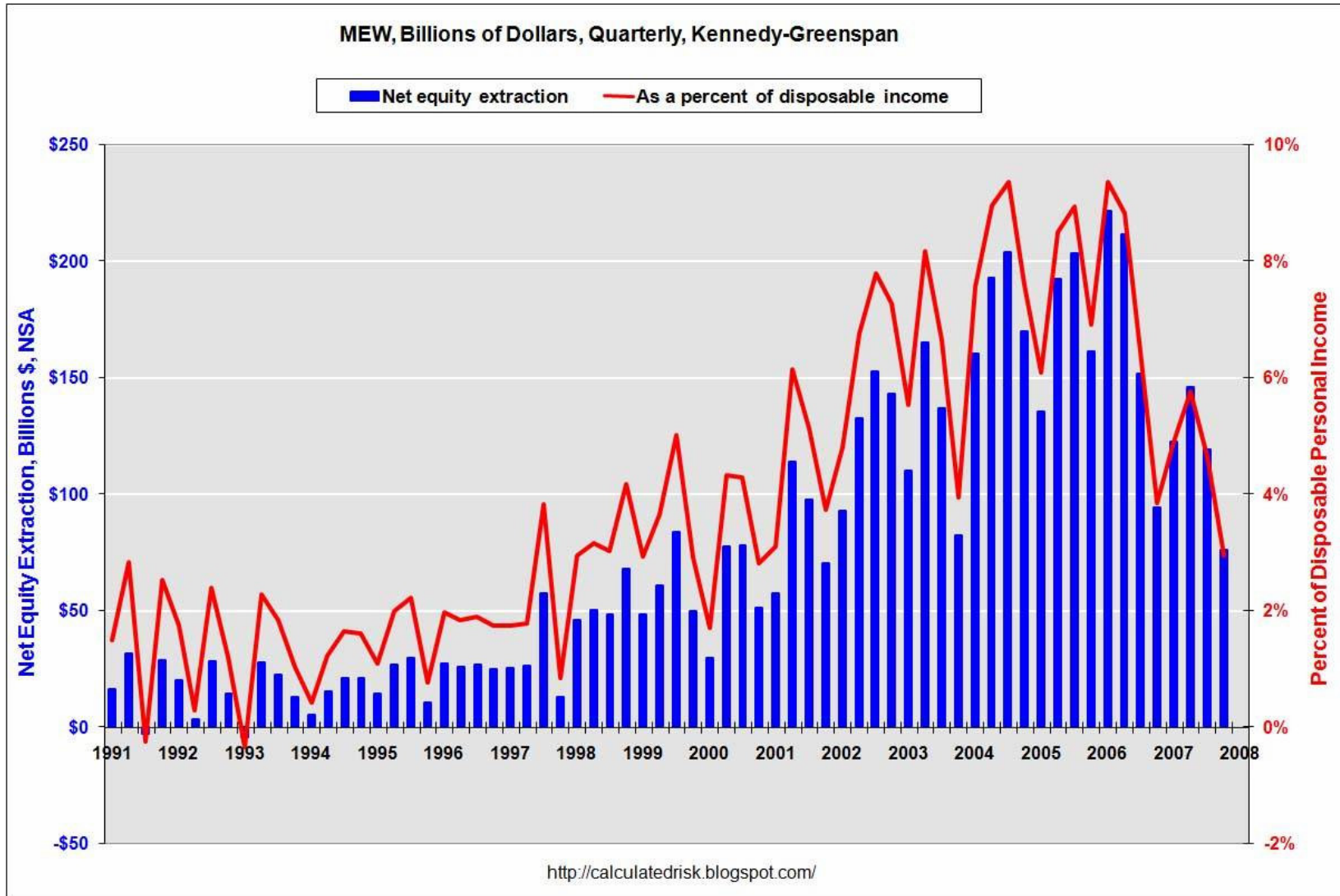


# Home Prices

Case-Shiller Index, Quarterly % Change, Annual Rate



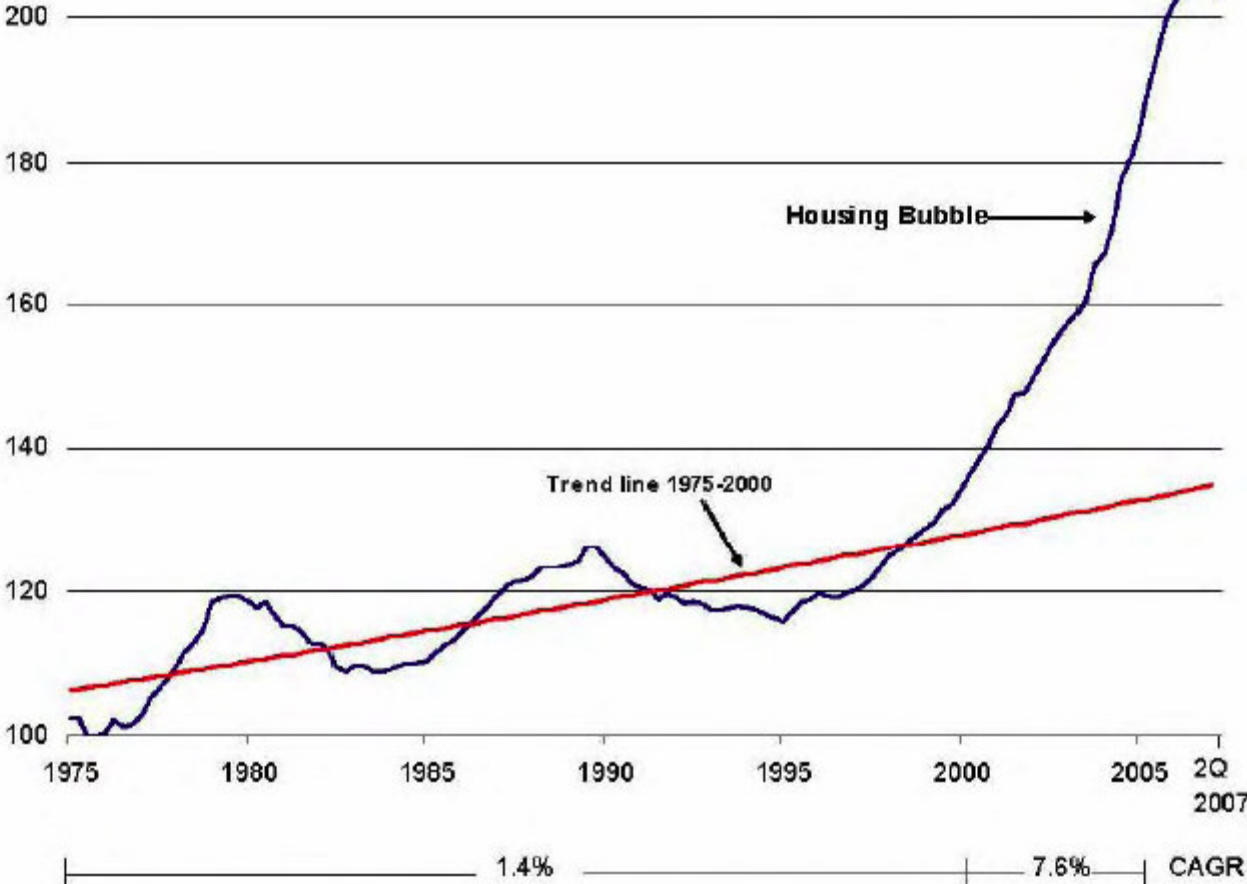
# Mortgage Equity Withdrawal



# The Housing Bust Has a Long Way to Go

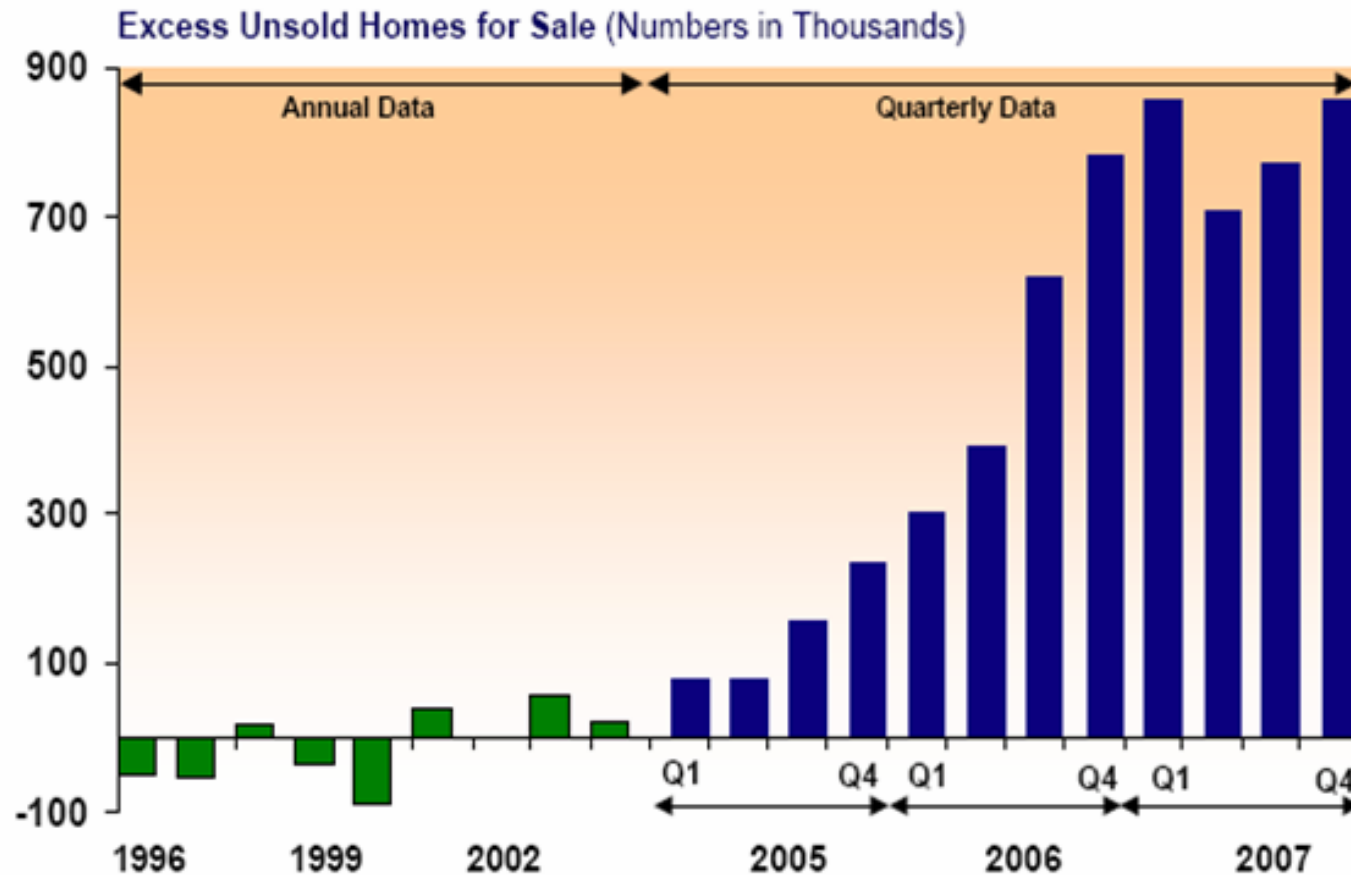
- Real home prices are still around 20 percent above their long run equilibrium.
- Excess housing inventories are in the region of 1 million homes.
- Sub-prime lending has all but dried up.
- Mortgage lending standards have tightened dramatically.
- Foreclosures are running at record levels and could spike higher as one third of households will have negative equity by end 2008.
- Housing market woes are likely to be compounded by a burst in the commercial property market.

Real Home Price Index (1975 = 100)



Sources: OFHEO, Bureau of Economic Analysis.

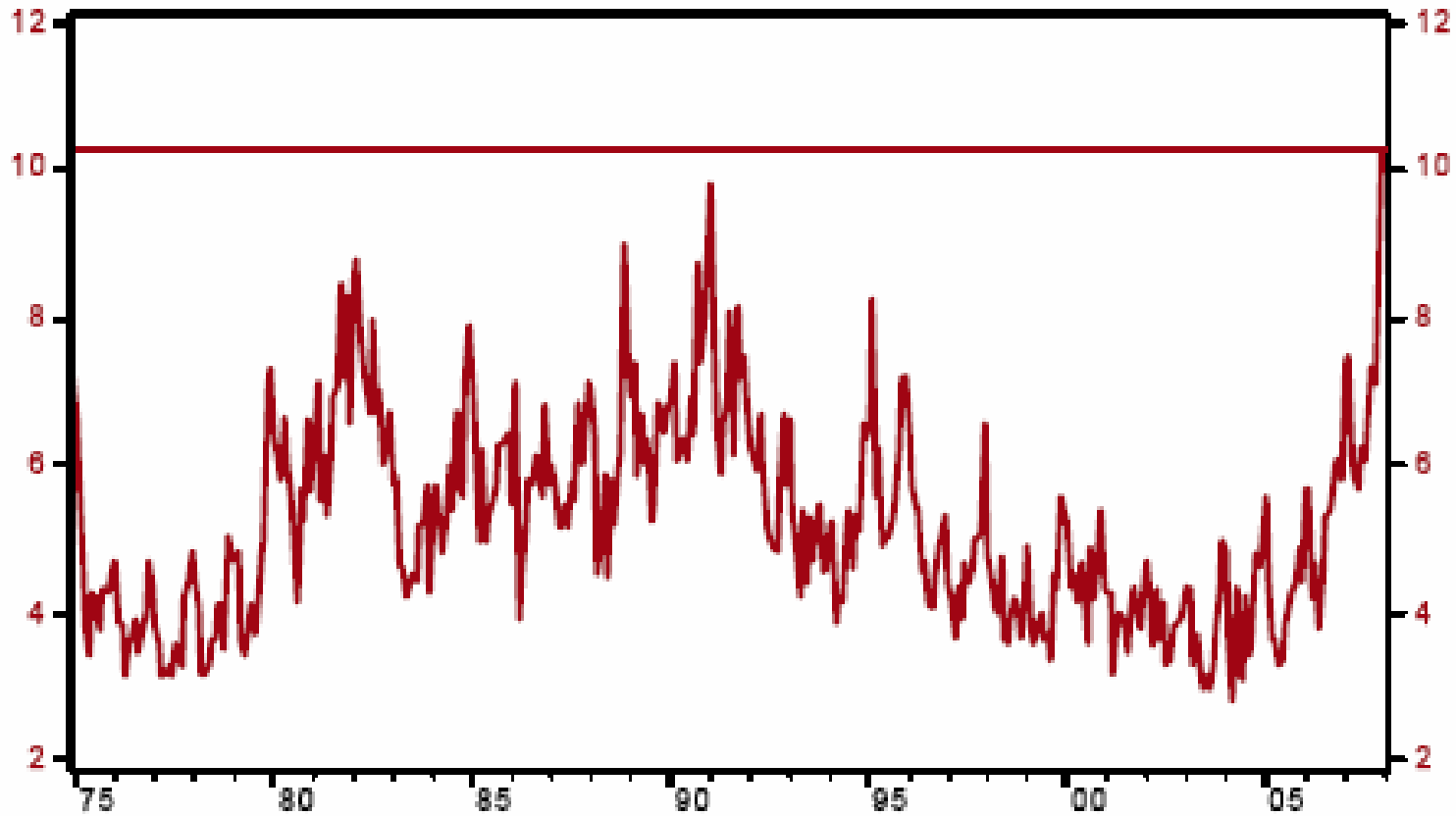
## A Large Inventory Overhang Remains within the Housing Market



Source: Bureau of Census (1996-2004:Annual Data, 2005Q1-2007Q4:Quarterly Data)  
 Note: The excess unsold homes were estimated based on the average vacancy rate from 1996Q1 to 2005Q4 (1.7%).

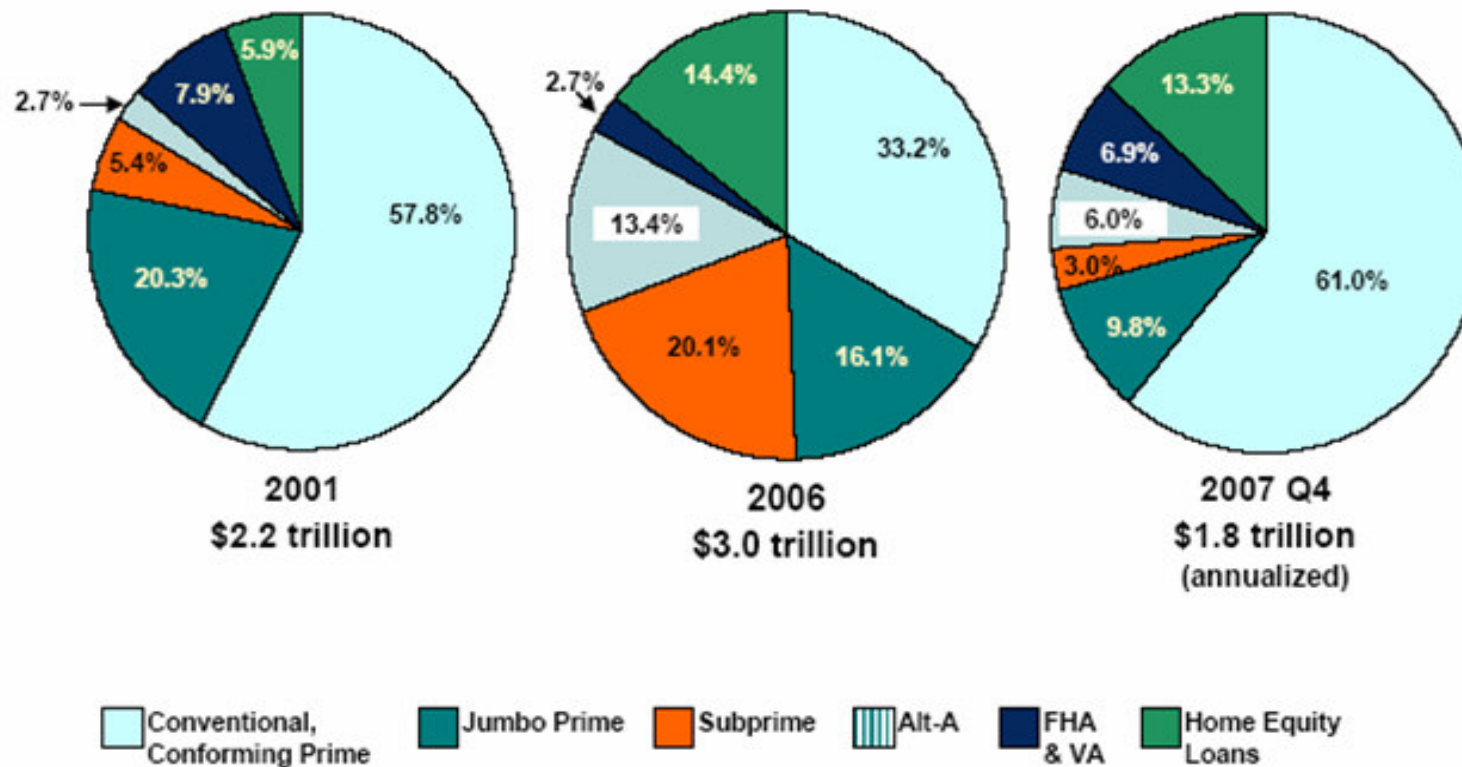
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## Unsold Housing Inventories (in months' supply)



Source: Haver Analytics, Merrill Lynch

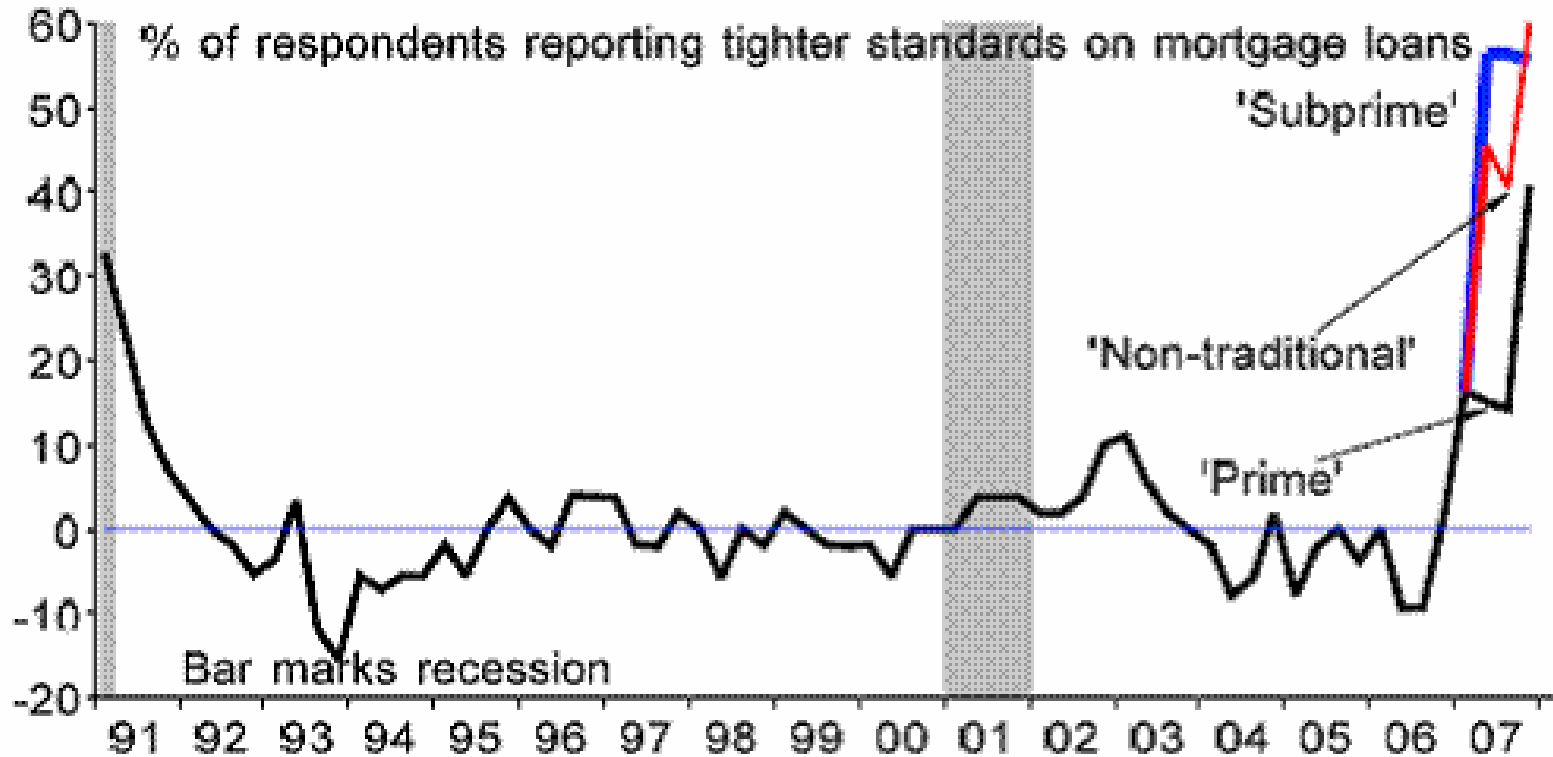
## Subprime and Alt-A Shares Quadrupled Between 2001 and 2006, then Fell in 2007



Source: Inside Mortgage Finance (by dollar amount)

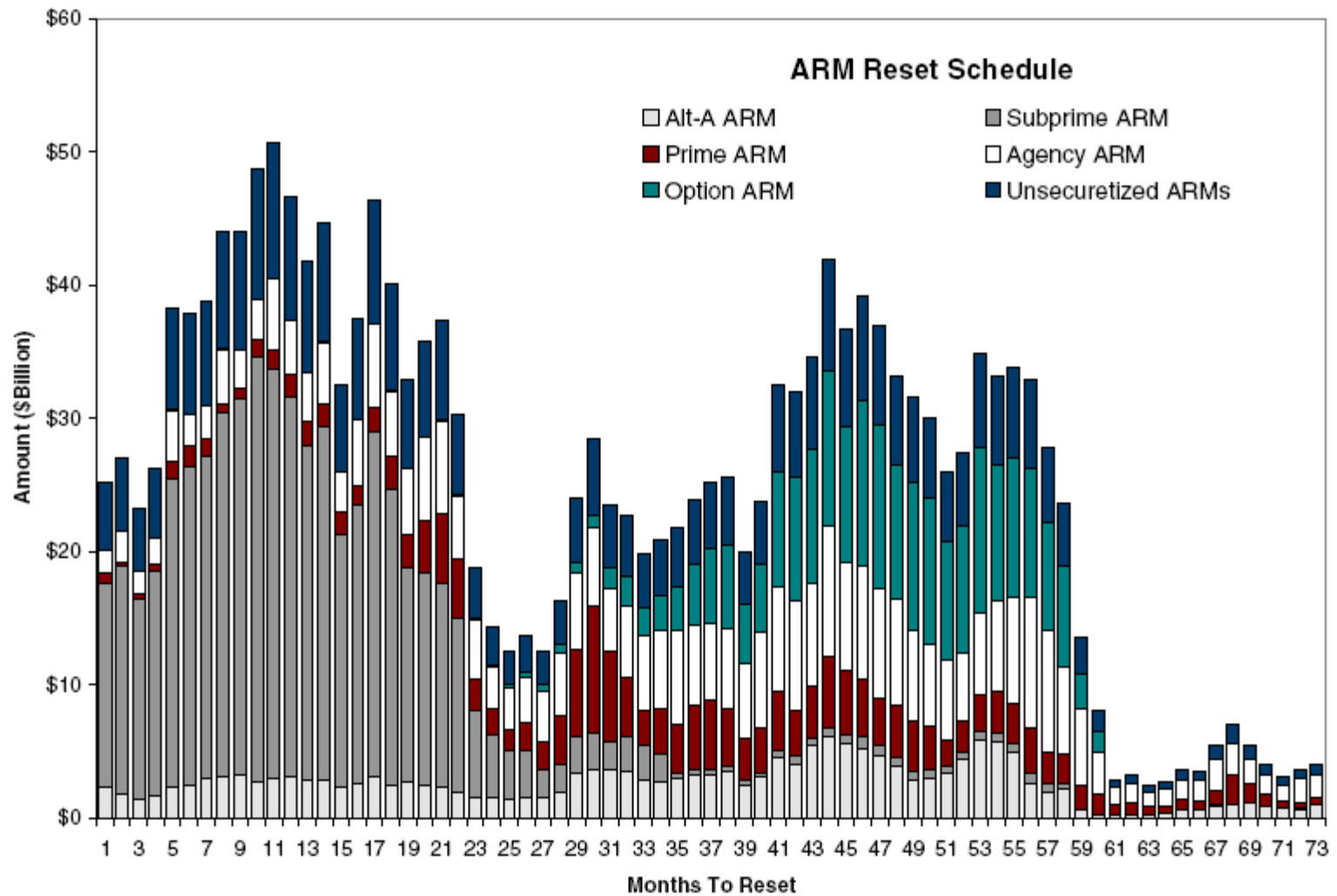
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**Chart 4: Ever More Stringent Mortgage Lending Conditions**



Source: Reuters EcoWin Pro

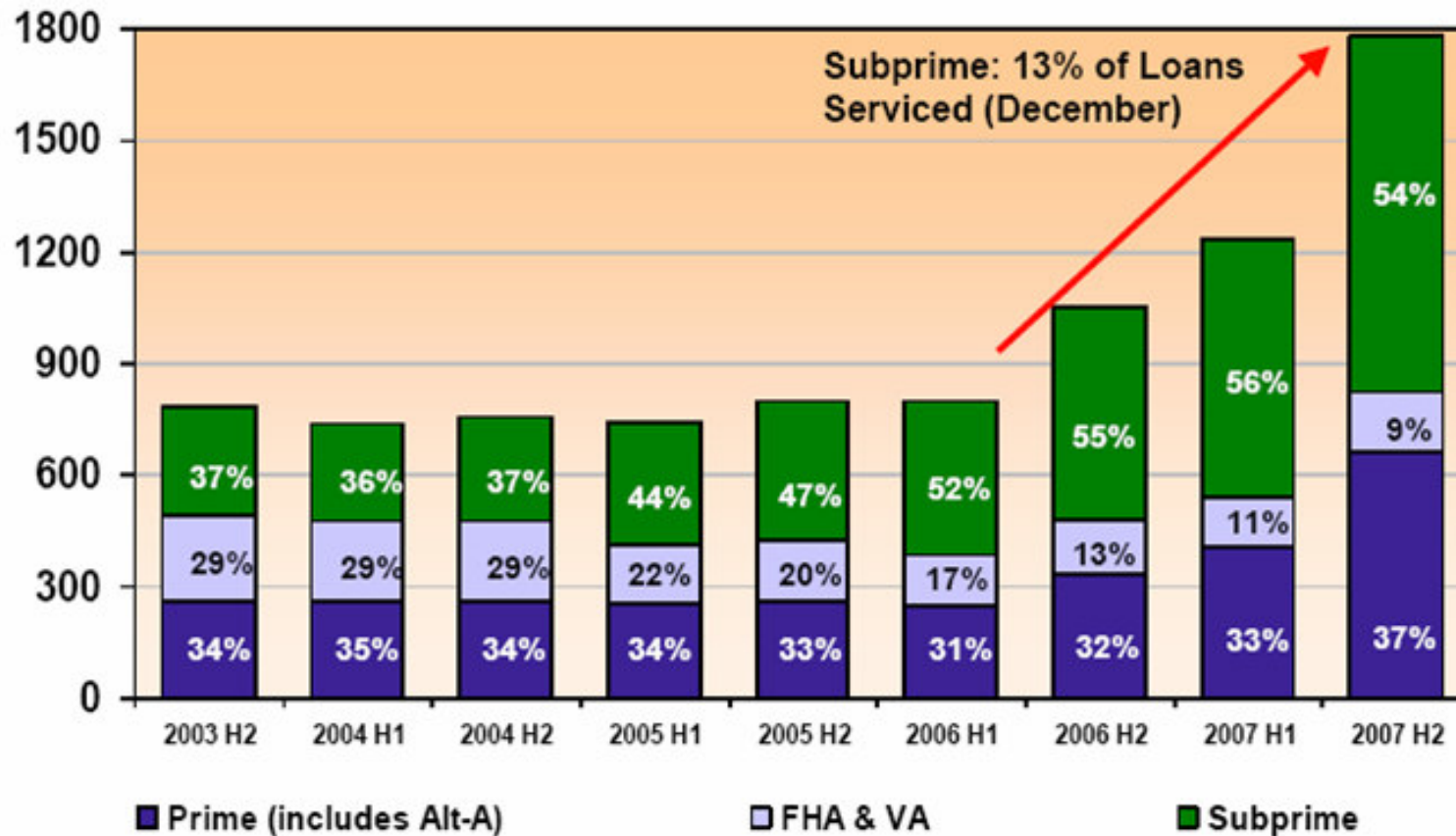
## Adjustable Rate Mortgage Reset Schedule



Note: Data as of January 2007.

Source: Credit Suisse Fixed Income U.S. Mortgage Strategy.

## Number of Foreclosures Started (Annualized Rate in Thousands)



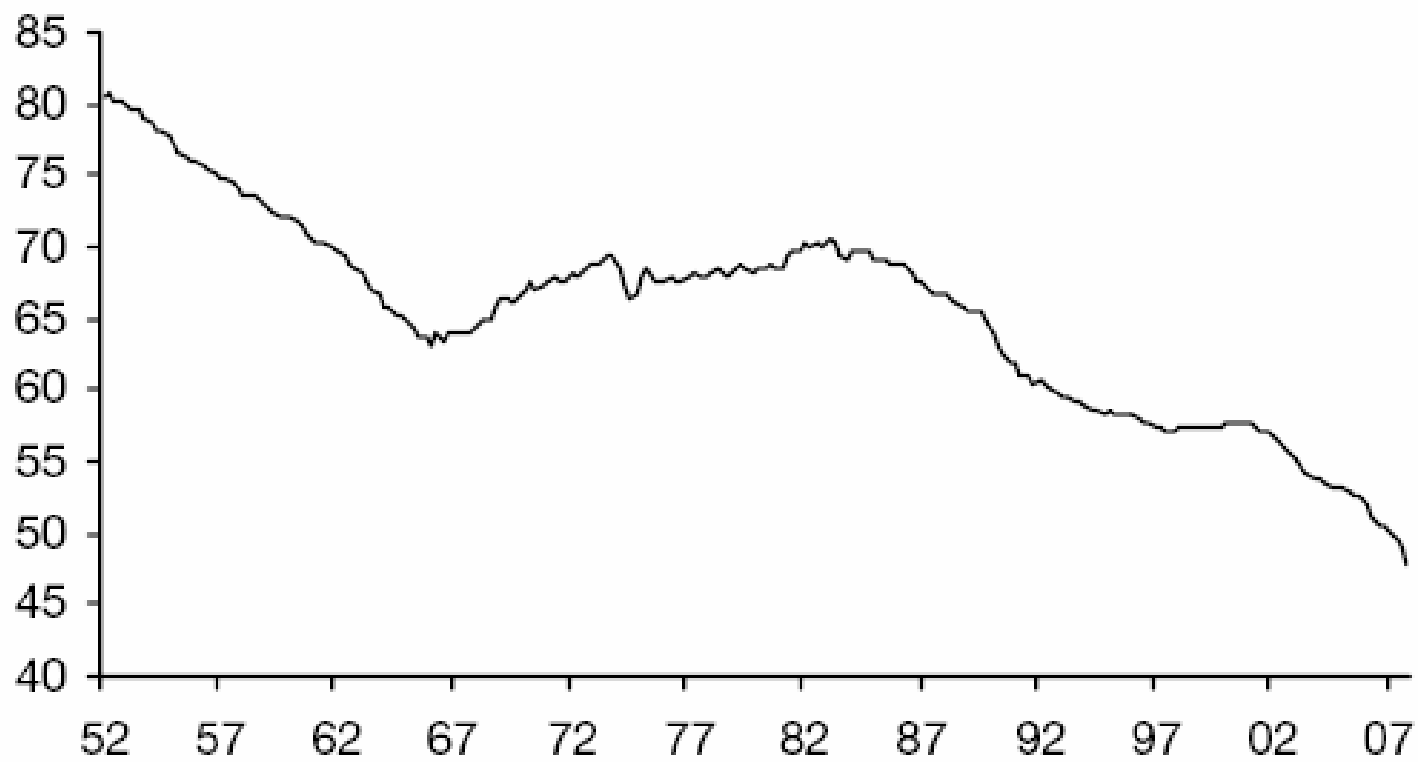
Source: Mortgage Bankers Association National Delinquency Survey  
 (Data as of December 2007; number expanded to reflect 85% coverage)

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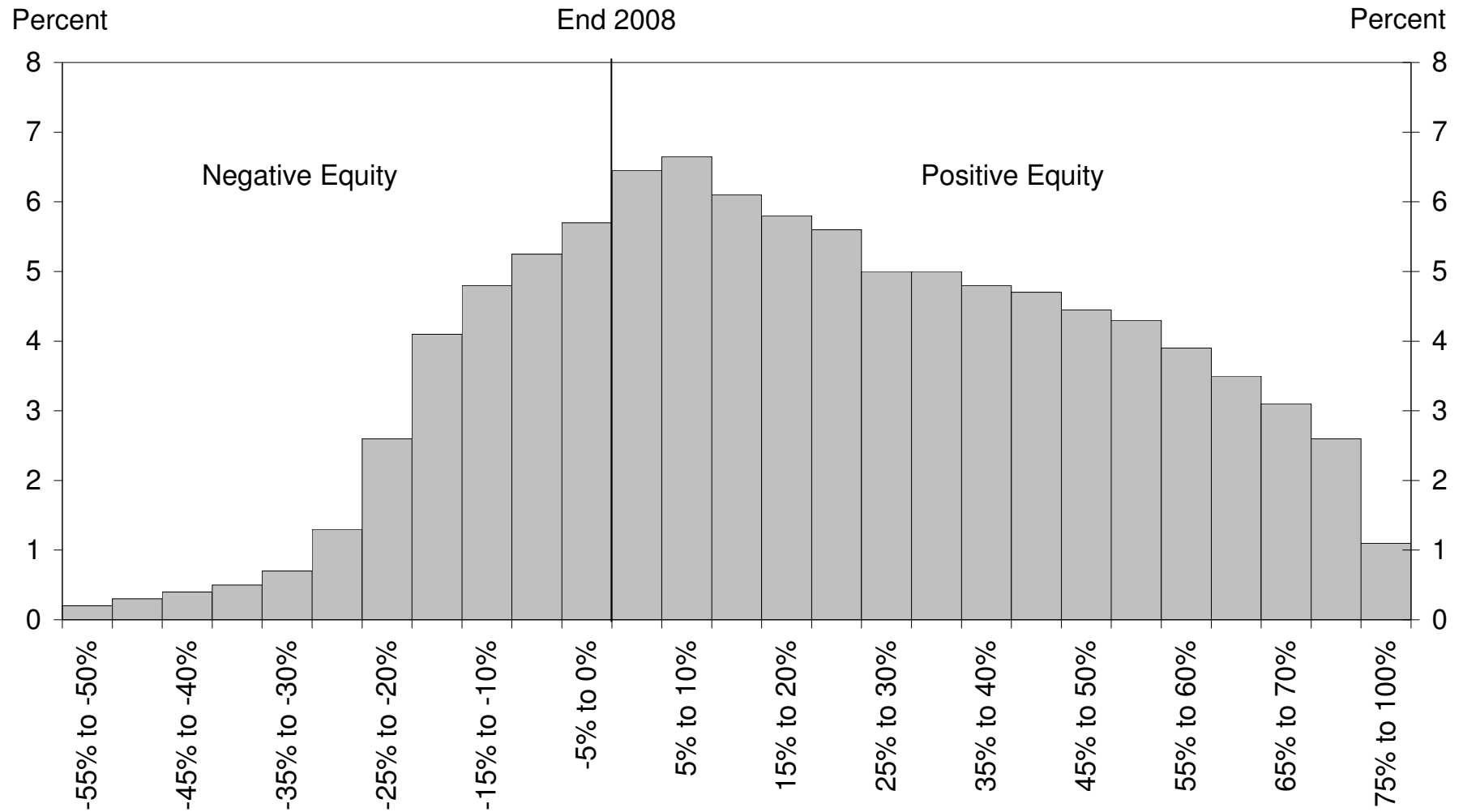
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## United States: Equity Share of Residential Real Estate Values

*percent*



## Falling Prices Leave Homeowners with Negative House Equity



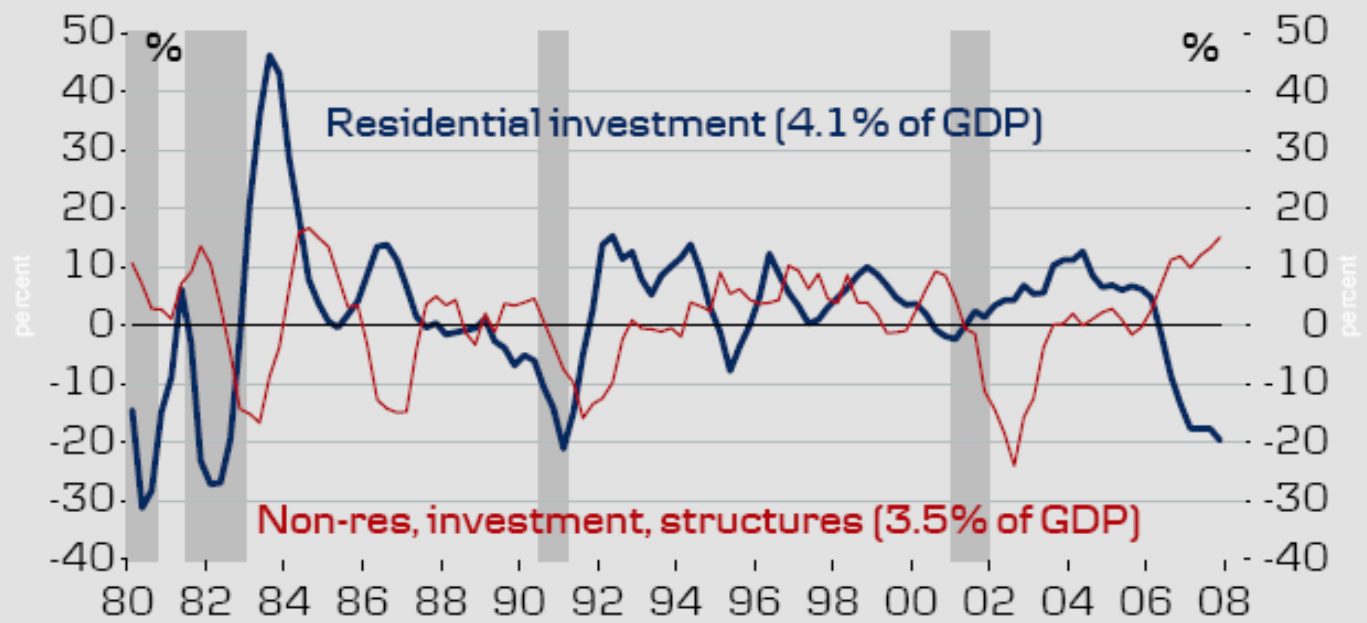
Source: First American CoreLogic, Inc.

## House price Declines Implied by Case-Shiller Future Contracts

<b>CUMULATIVE % CHANGE IN HOME PRICES, NOVEMBER-NOVEMBER</b>				
<b>CITY</b>	<b>2007-2008</b>	<b>2007-2009</b>	<b>2007-2010</b>	<b>2007-2011</b>
<b>Boston</b>	-10.4%	-11.6%	-12.1%	-12.1%
<b>Chicago</b>	-10.0%	-7.7%	-7.8%	-5.6%
<b>Denver</b>	-15.0%	-16.9%	-18.4%	-16.2%
<b>Las Vegas</b>	-28.8%	-30.2%	-25.0%	-26.4%
<b>Los Angeles</b>	-32.5%	-33.3%	-32.5%	-12.5%
<b>Miami</b>	-22.2%	-25.3%	-26.8%	-24.0%
<b>New York</b>	-8.0%	-11.8%	-14.2%	-15.8%
<b>San Diego</b>	-24.5%	-26.8%	-27.3%	-21.9%
<b>San Francisco</b>	-24.0%	-26.4%	-24.1%	-24.4%
<b>Washington, DC</b>	-14.9%	-15.8%	-12.9%	-14.6%

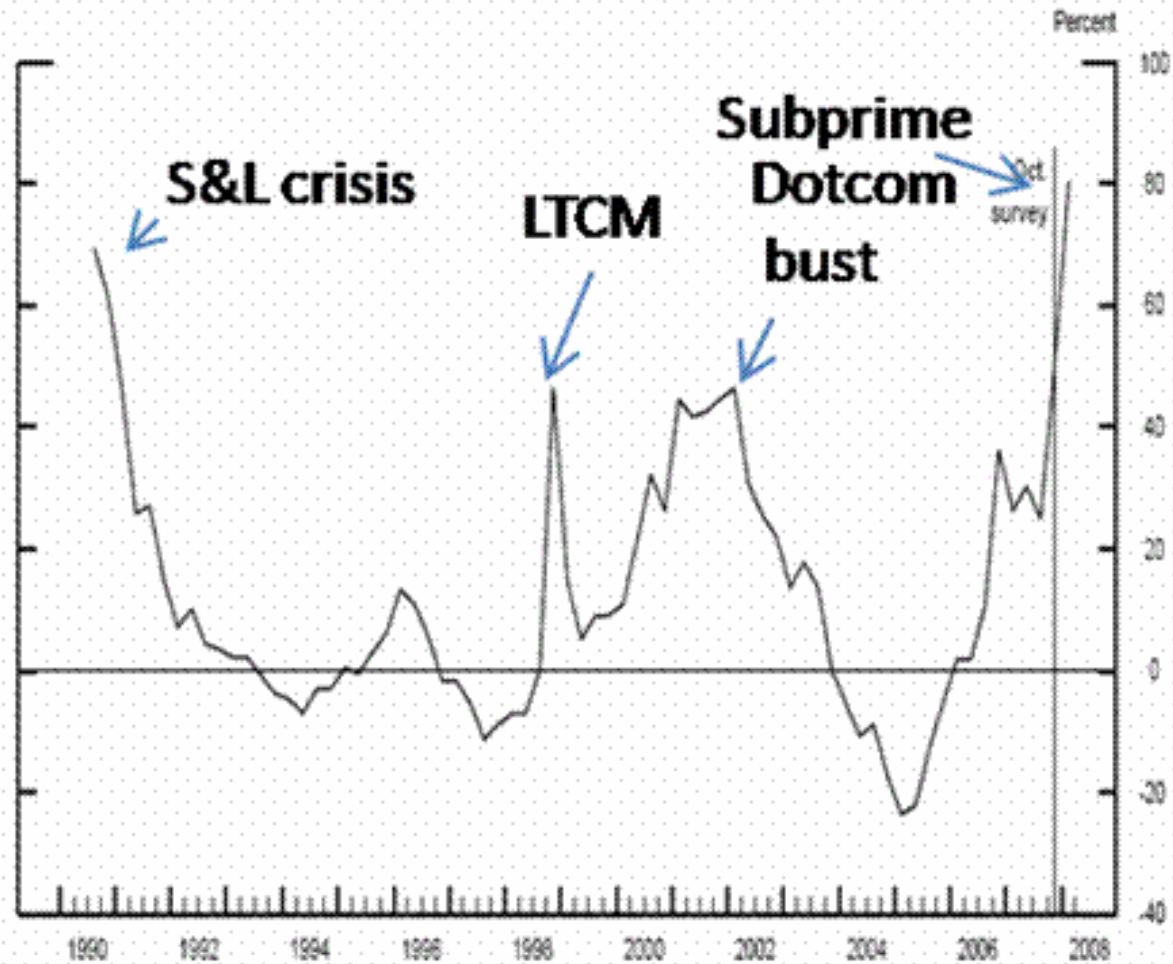
Data as of April 8, 2008. Note that these contracts cover prices with a two-month lag, and that they average prices over three months, so the November 2007 contract actually covers prices from July-September 2007.

## Residential and non-residential construction spending



## Measures of Supply and Demand for Commercial Real Estate Loans

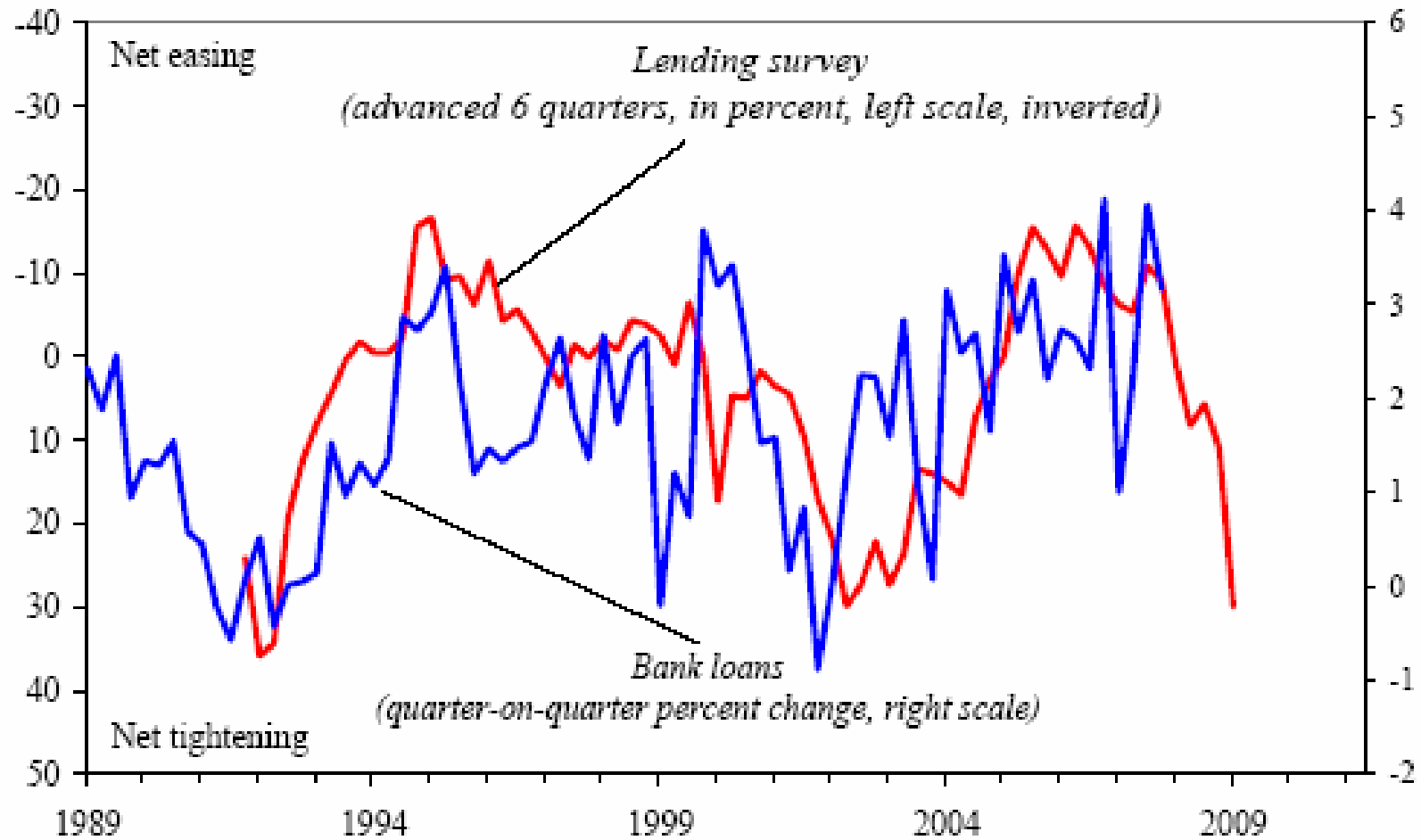
Net Percentage of Domestic Respondents Tightening Standards for Commercial Real Estate Loans



# The Credit Crunch Shows No Sign of Letting Up

- Goldman Sachs now estimates total loan losses to financial system at U.S. \$1.2 trillion of which mortgage losses will be US\$500 billion
- Bank lending conditions have tightened dramatically
- Interest Rate Spreads have widened thereby offsetting the Fed's monetary policy easing
- Dangers lurk in the non-bond section of the financial system
- Credit default swap market has exploded and now has face value of U.S. \$45 trillion

## U.S. Bank Credit and Lending Conditions

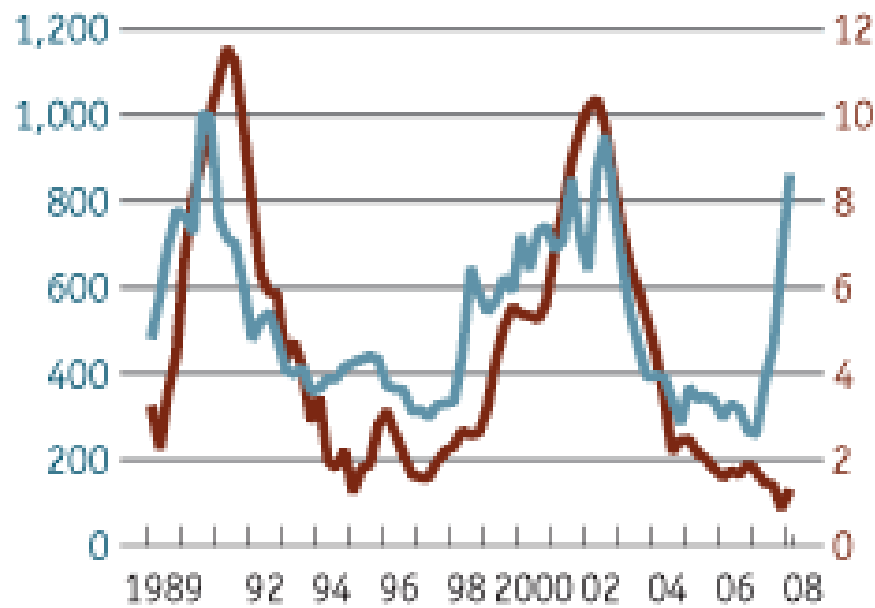


Sources: Bloomberg L.P.; and Board of Governors of the Federal Reserve System.

### Speculative-grade bonds:

*spreads,*  
*basis points*

*default rate,*  
*%*



Source: Moody's

### Jumbo Mortgage Spread



Source: BankRate.com.

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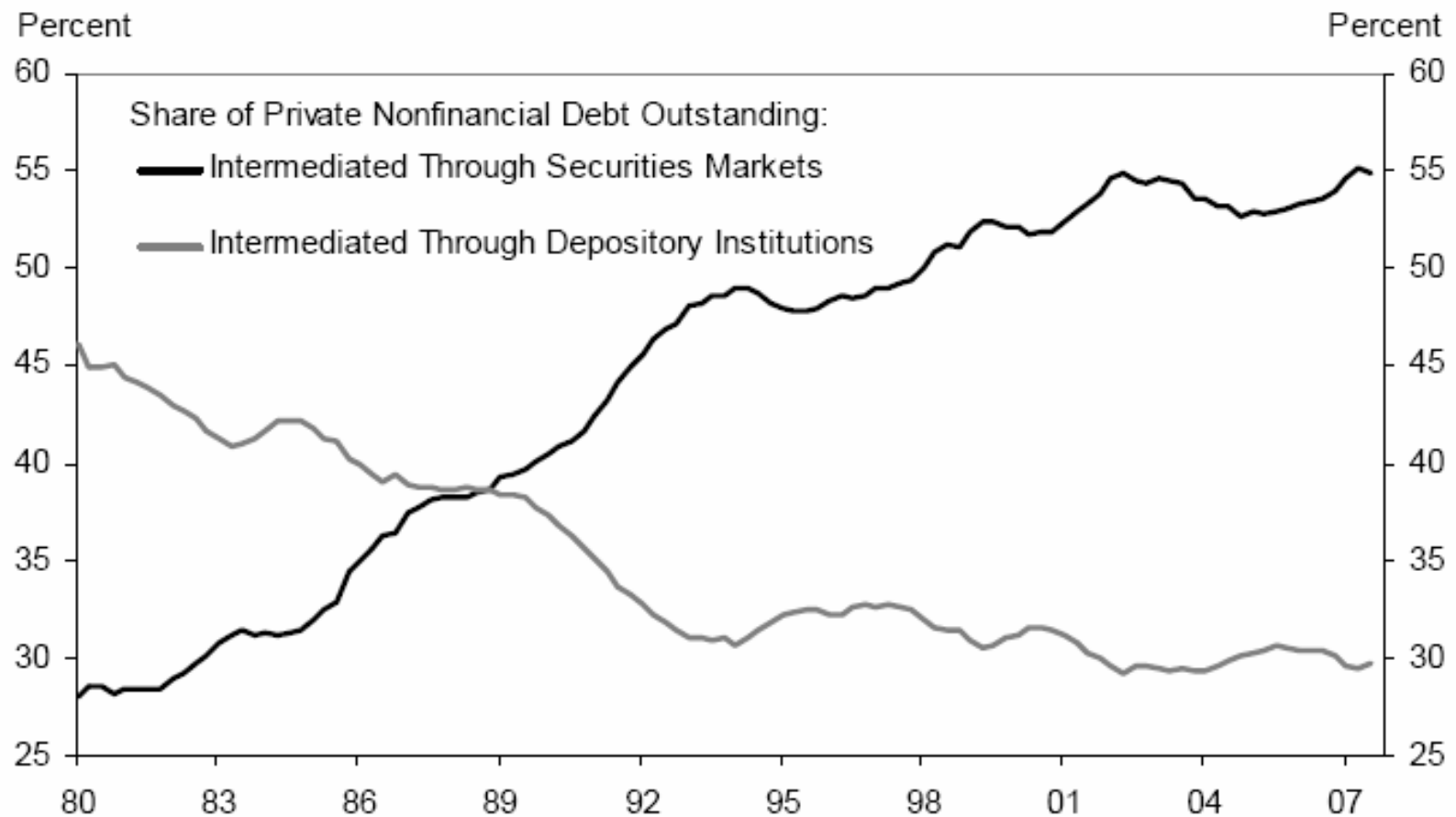
## 6: CDX North America Inv Grade 5y

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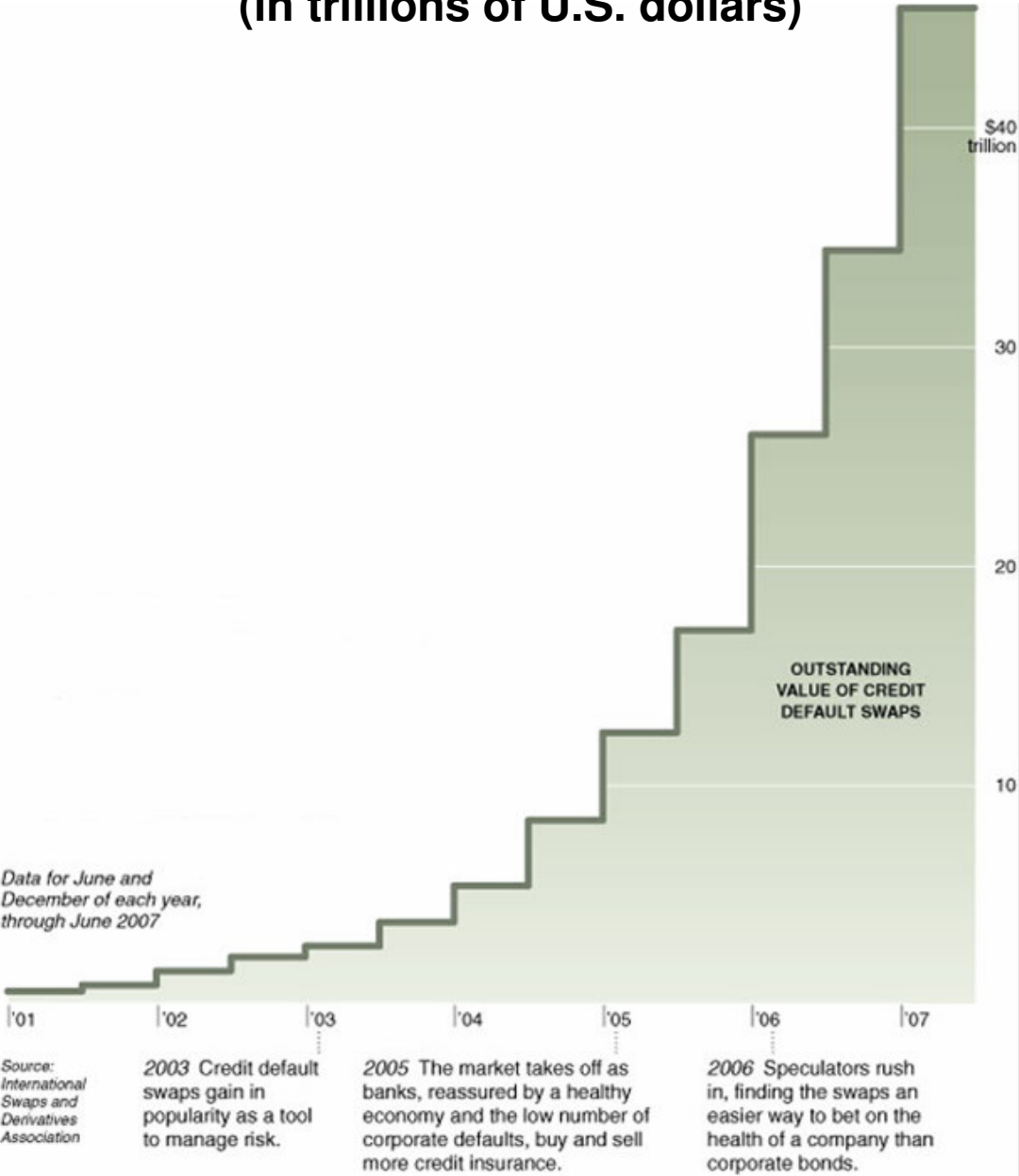
Source: BNP Paribas

## Share of Intermediation through Banks and Securities Markets



Source: Morgan Stanley calculations based on Federal Reserve Flow of Funds Accounts.

# Face Value of Credit Default Swaps Outstanding (in trillions of U.S. dollars)



# Policy Response Needs Strengthening

- Federal Reserve interest rate cuts have been offset by widening credit spreads
- The fiscal stimulus package has been neutralized by higher oil prices
- Further interest rate cuts and a second stimulus package are required
- Unorthodox measures are needed to stabilize the housing market