

# Credit Crisis Seminar III

Desmond Lachman

American Enterprise Institute

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# The End of the Beginning

- The US is experiencing its worst financial and economic crisis since the 1930s
- The US recession will be the deepest and longest in the postwar period
- A cause for optimism is that policymakers are no longer in denial and recognize the severity of the crisis
- The Paulson Plan will not stop either home prices from continuing to fall or the bank de-leveraging process from continuing apace
- A new Administration will need to pursue unorthodox and bold policies to avert the threat of a lost decade.

# A Confluence of Negative Shocks

- The U.S. economy continues to be hit by a confluence of adverse shocks
- The worst housing market bust in the post-war period
- A credit crisis that Alan Greenspan describes as “a once or twice in a century event”
- A bear market in equities that has destroyed more than U.S. \$3 trillion in U.S. household wealth
- The bursting of the commercial property market bubble
- A major international oil price shock

# Change in U.S. Housing Prices, Stocks, and Bonds



Source: PIMCO

# Commercial Real Estate Price Index- United States



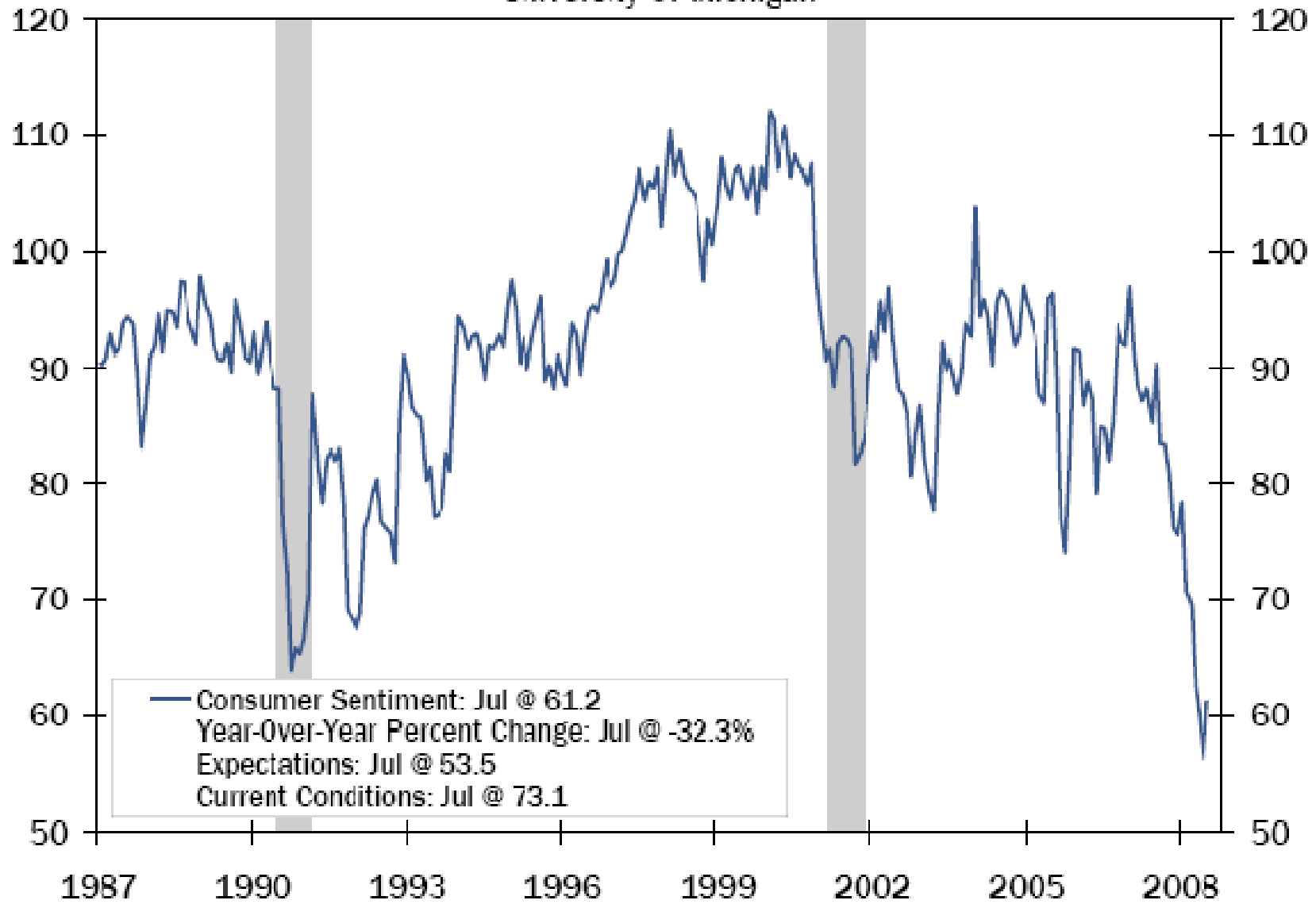
# The U.S. Faces a Difficult Economic Environment

- Employment has declined each month in 2008 while unemployment has risen to over 6 percent
- Income growth has slowed, while consumer confidence remains at close to 28 year lows
- Regional Banks now appear to be in deep trouble
- Europe and Japan are now on the brink of recession while the dollar is appreciating
- The positive effect of the fiscal stimulus package is fading



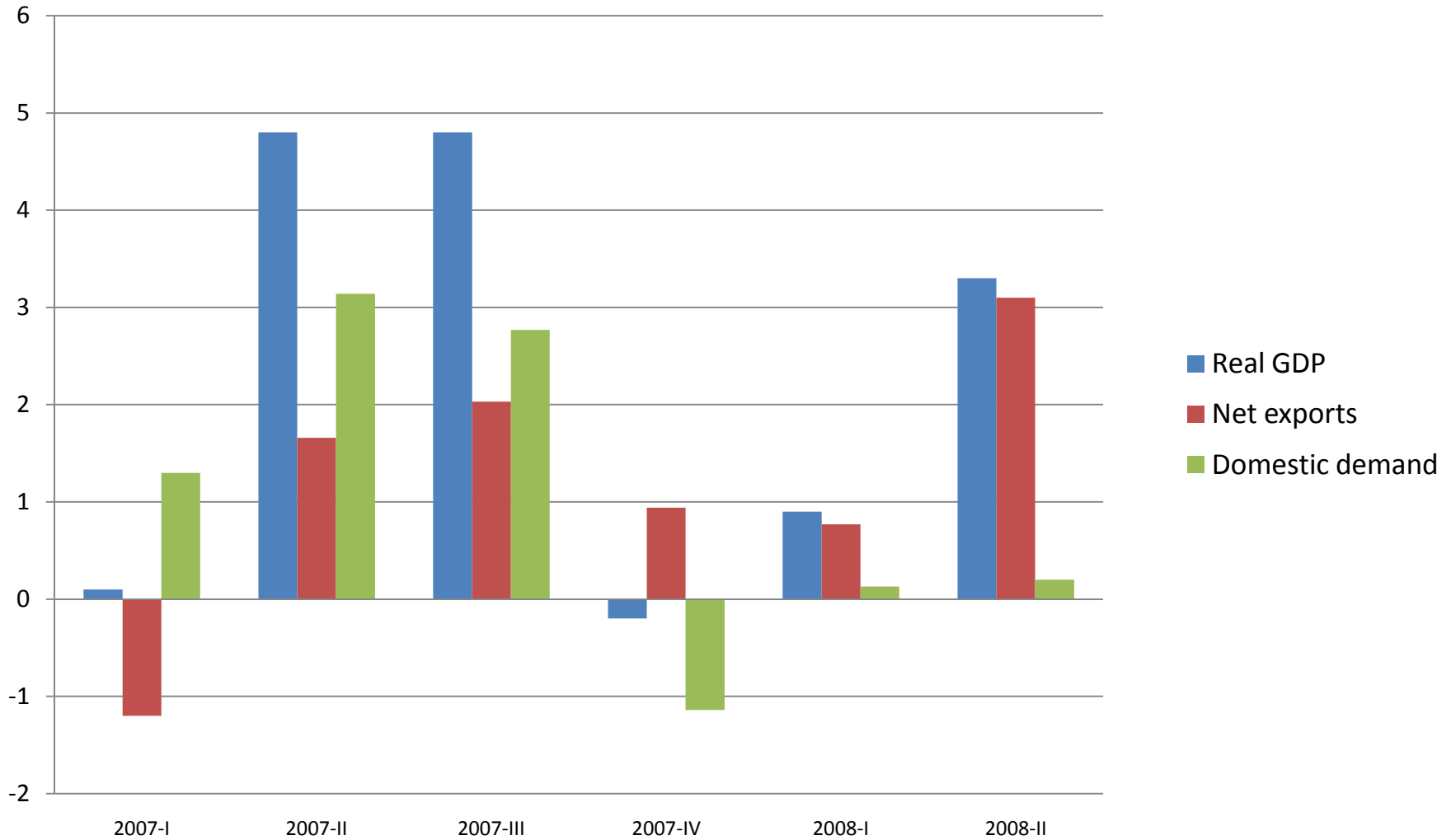
# Consumer Sentiment Survey

University of Michigan

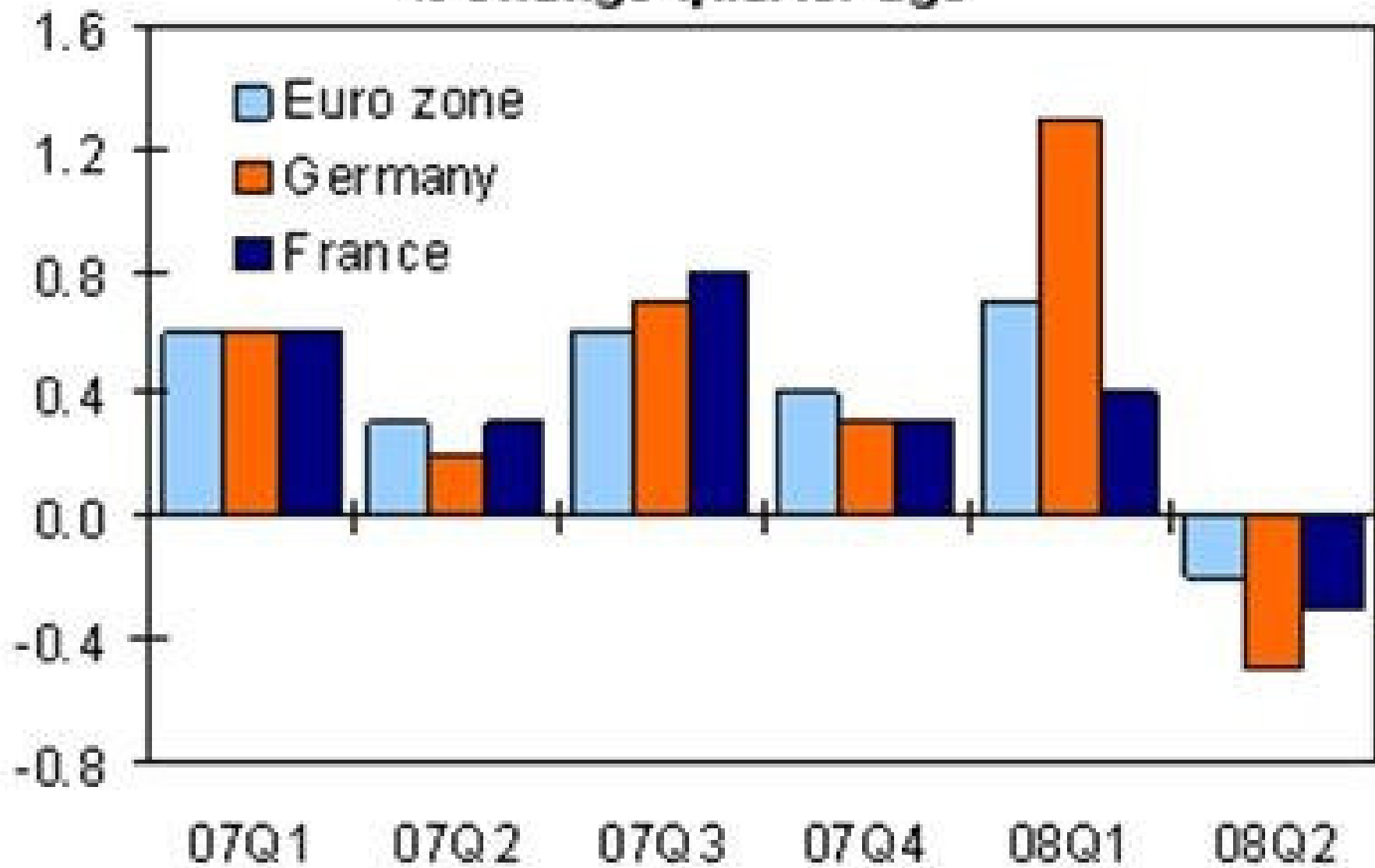


# US Quarterly Economic Growth 2007-2008

percent



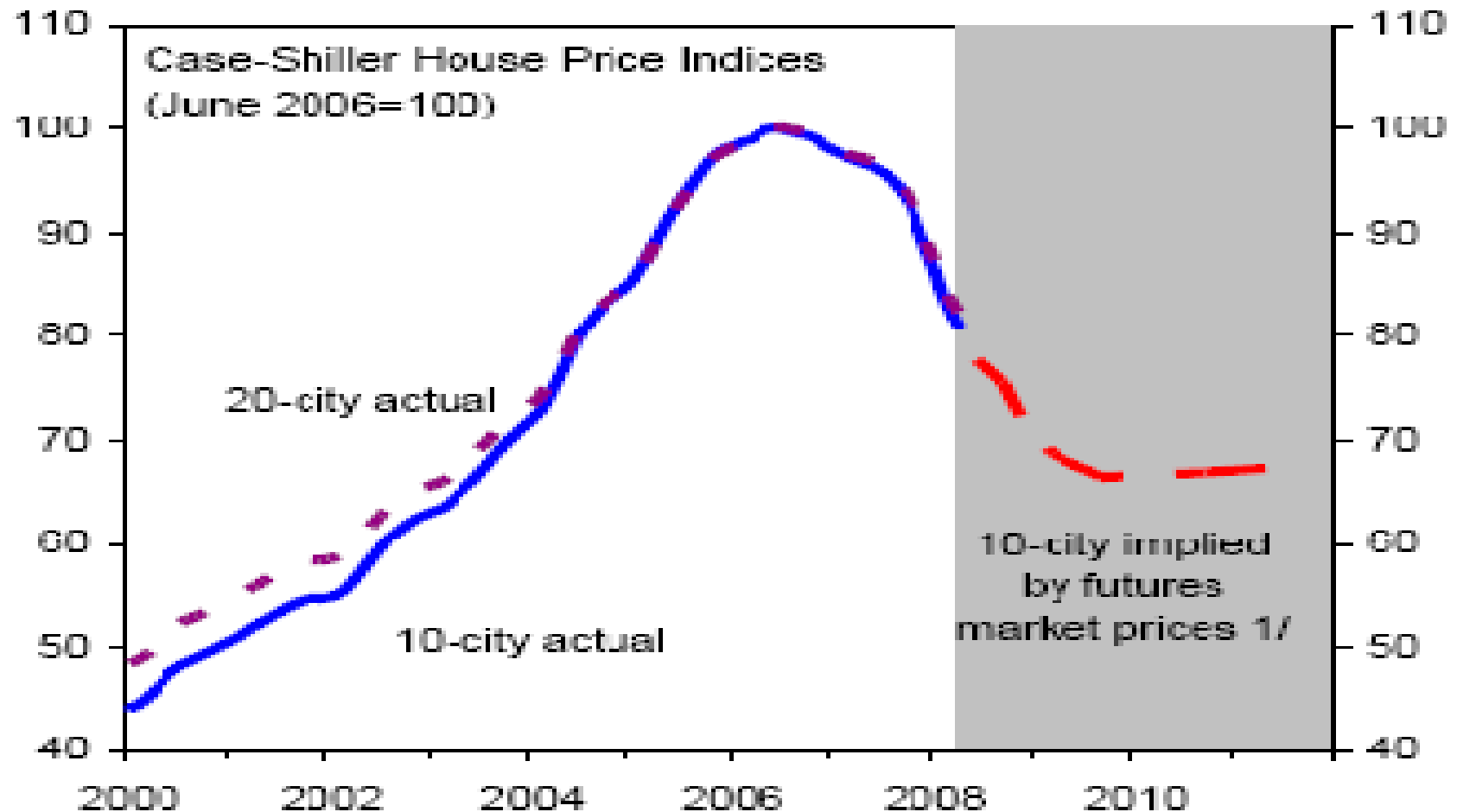
## Euroland Economic Growth Cooling % change quarter ago



# The Housing Market Shows no Signs of Stabilizing

- Over the past year, home prices as measured by the Case-Shiller Index fell by 16 percent
- Unsold housing inventories remain at close to record levels of around 11 months' supply
- Around one in three households will have negative equity in their homes by end-2008
- Foreclosure procedures initiated are running at an annual rate of 3 million units
- Private mortgage credit has all but dried up
- Around U.S. \$ 100 billion in option-ARMs reset over the next two years

## House Prices



Sources: Haver Analytics; Bloomberg, L.P.; and Fund staff calculations.

1/ Illiquidity in market may lend a downward bias to prices implied by futures contracts.

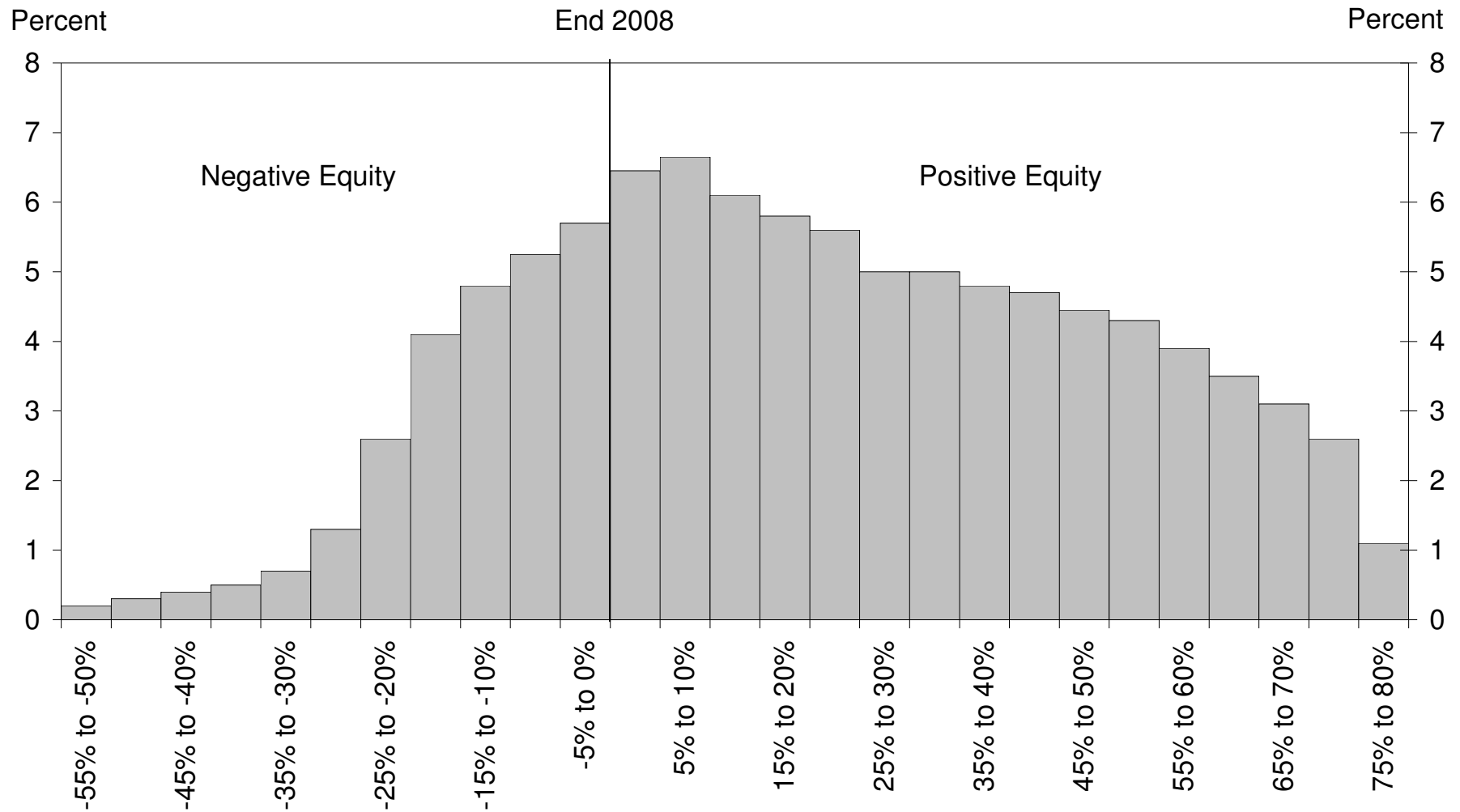
## U.S. Housing Starts and Months Supply of Existing Homes

thousands,  
at annual rates

level, months supply at  
current sales rate



# Falling Prices Leave Homeowners with Negative House Equity



Note: All data as of December 2006.  
 Source: First American CoreLogic, Inc.

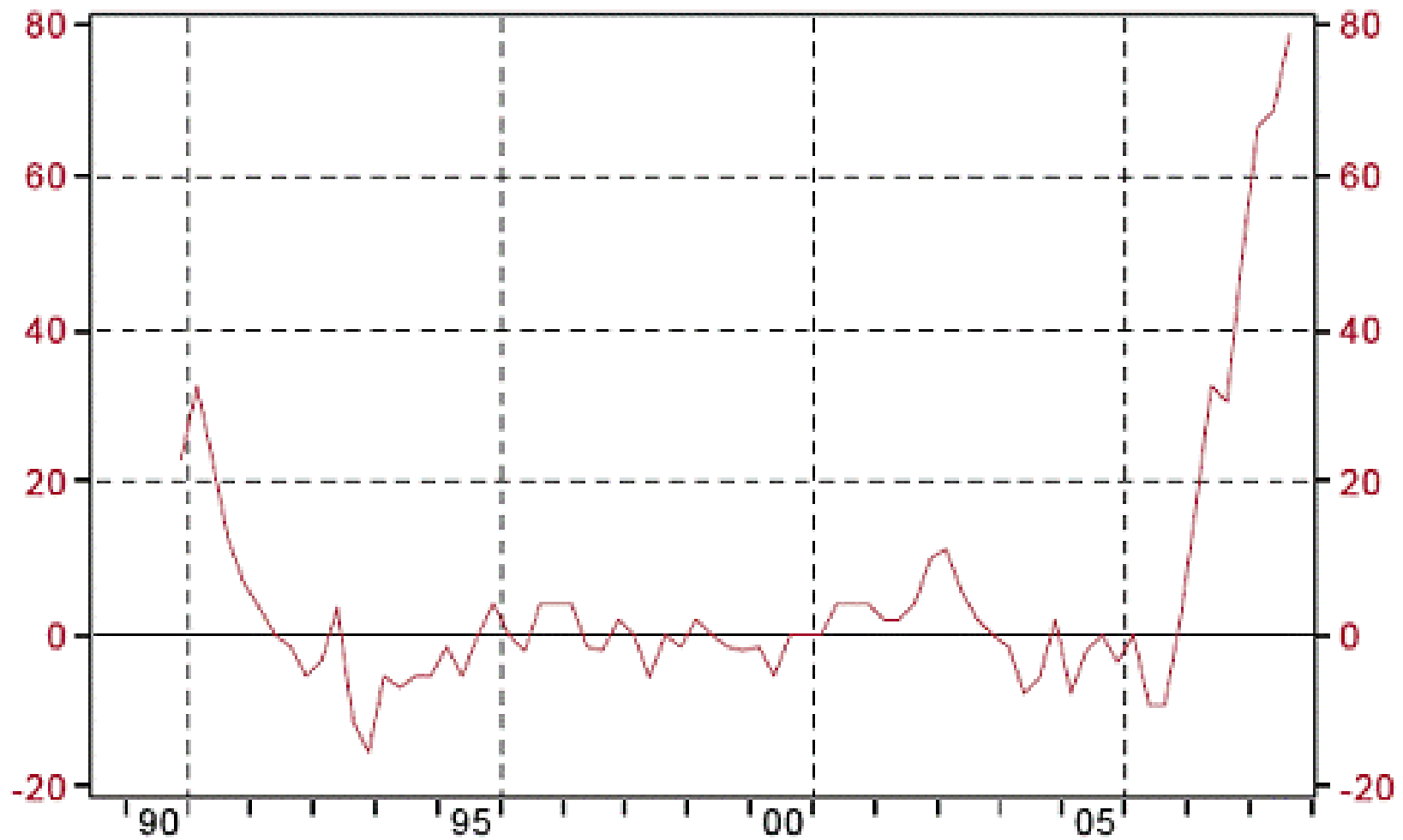
# Foreclosures Surge...

**First mortgage loan defaults, ths, SAAR**



# FRB Sr Loan Survey: Res Mortgages: Net Share, Banks Tightening

Haver Est, %



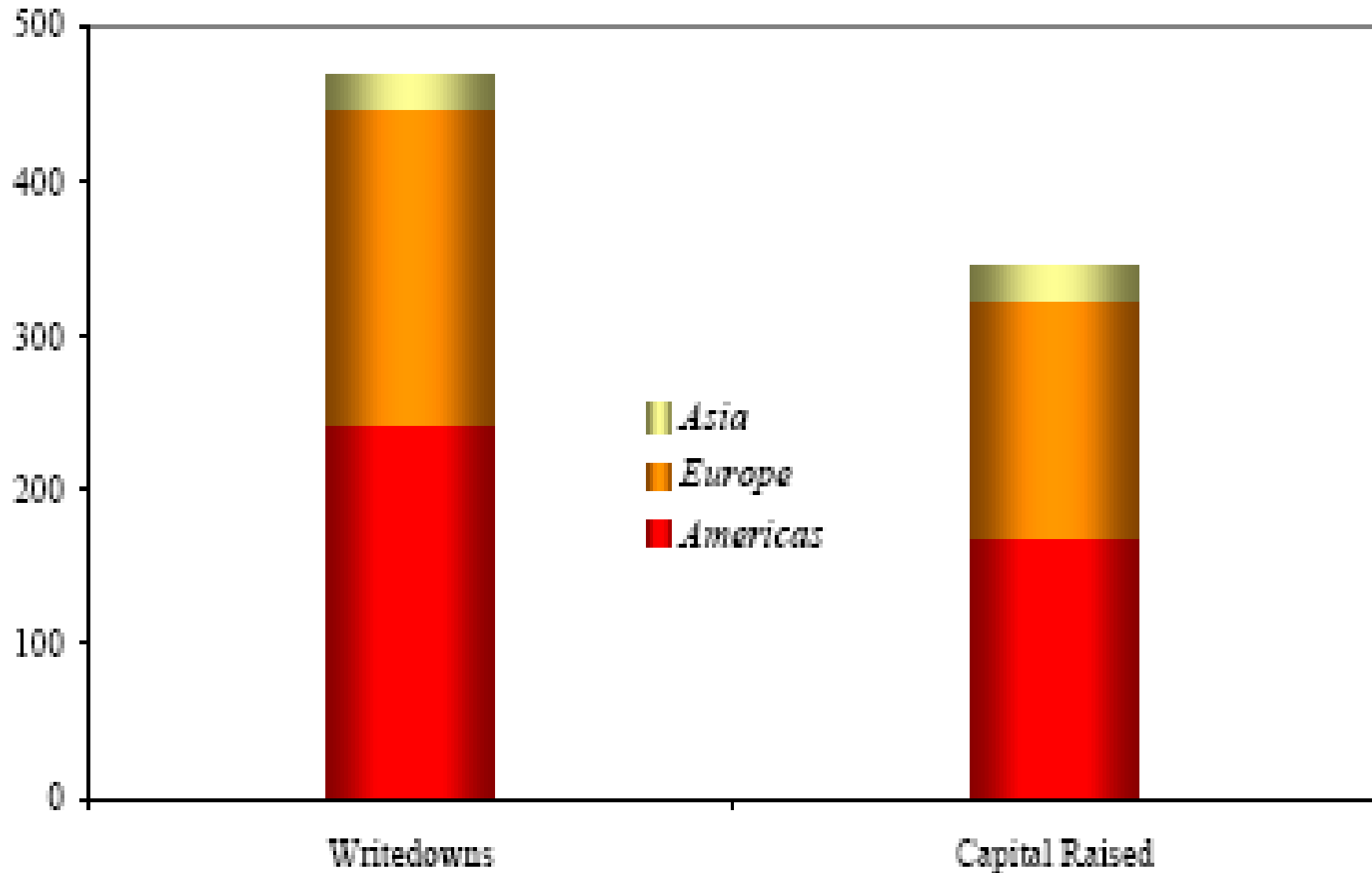
Source: Federal Reserve Board /Haver Analytics

# De-leveraging is Intensifying the Credit Crisis

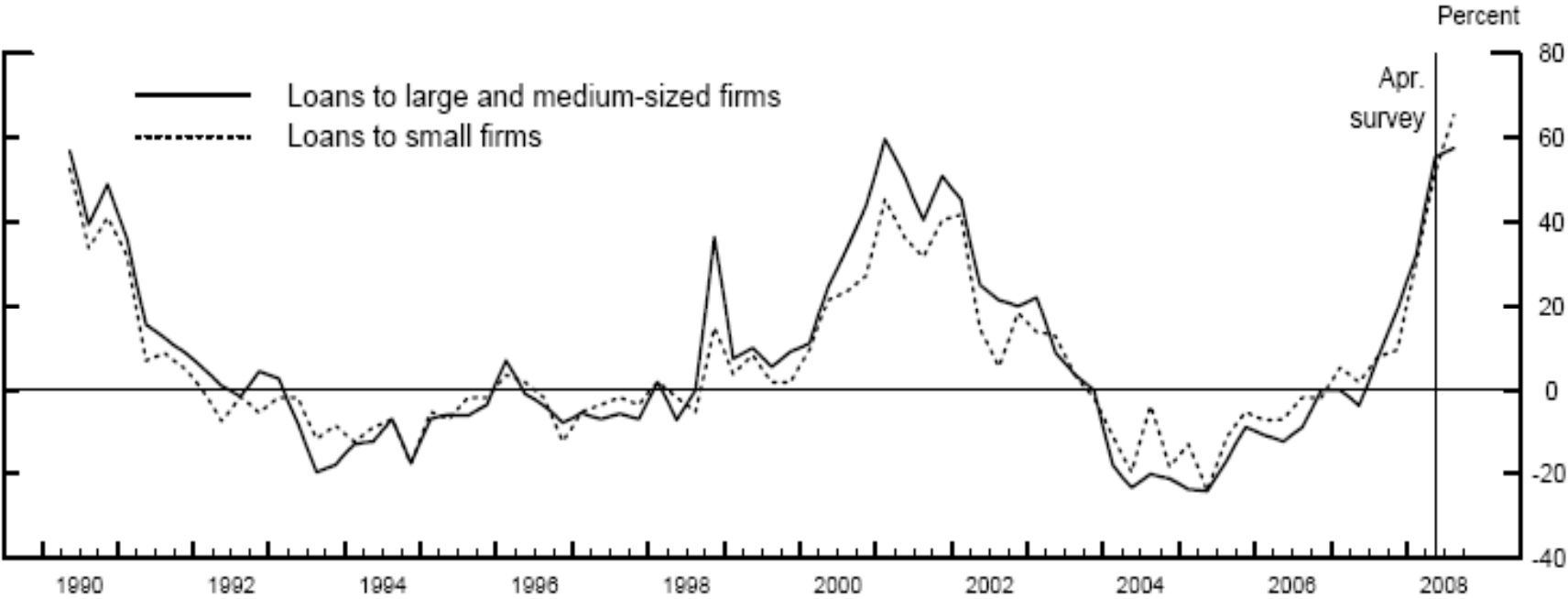
- The global banking system has acknowledged U.S. \$ 500 billion in loan losses and raised only U.S. \$ 350 billion in new capital
- The IMF now estimates that global loan losses could be US\$1.3 trillion
- Banks are now all trying to de-leverage at the same time, which is leading to a vicious cycle
- Interest rates have widened to record levels, more than offsetting the Fed's monetary policy easing
- Bank credit is now contracting at the fastest pace in the post-war period
- The financial markets are virtually frozen and interest rate spreads are higher than in August 2007.

# Bank Writedowns and Capital Raised

*(in billions of U.S. dollars)*



# Federal Reserve Senior Loan Officer Survey for Commercial and Industrial Lending

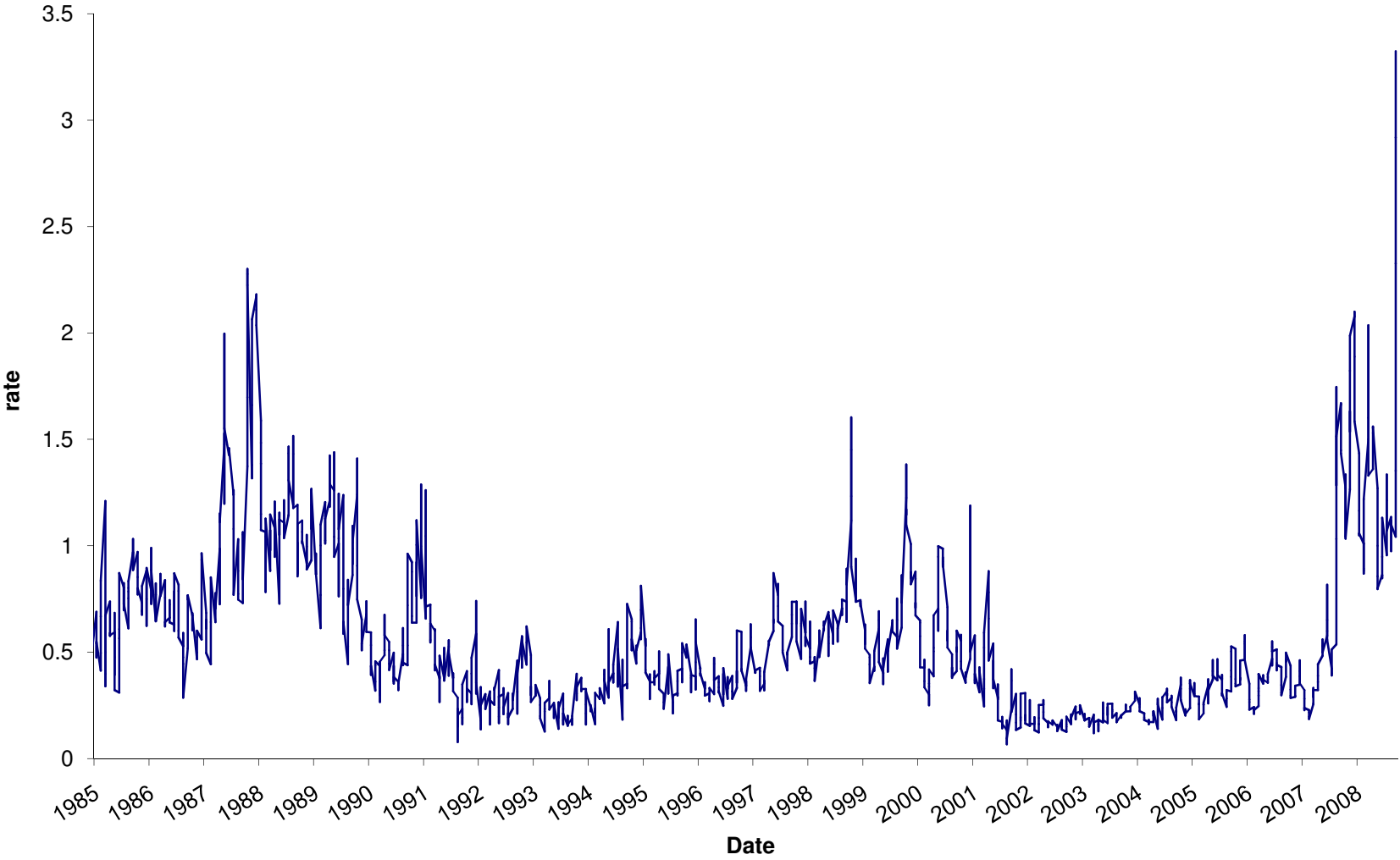


Source: Federal Reserve Senior Loan Officer Survey

# Spreads vs. 10-Year Treasuries- United States (ppts)



### U.S. Ted Spread

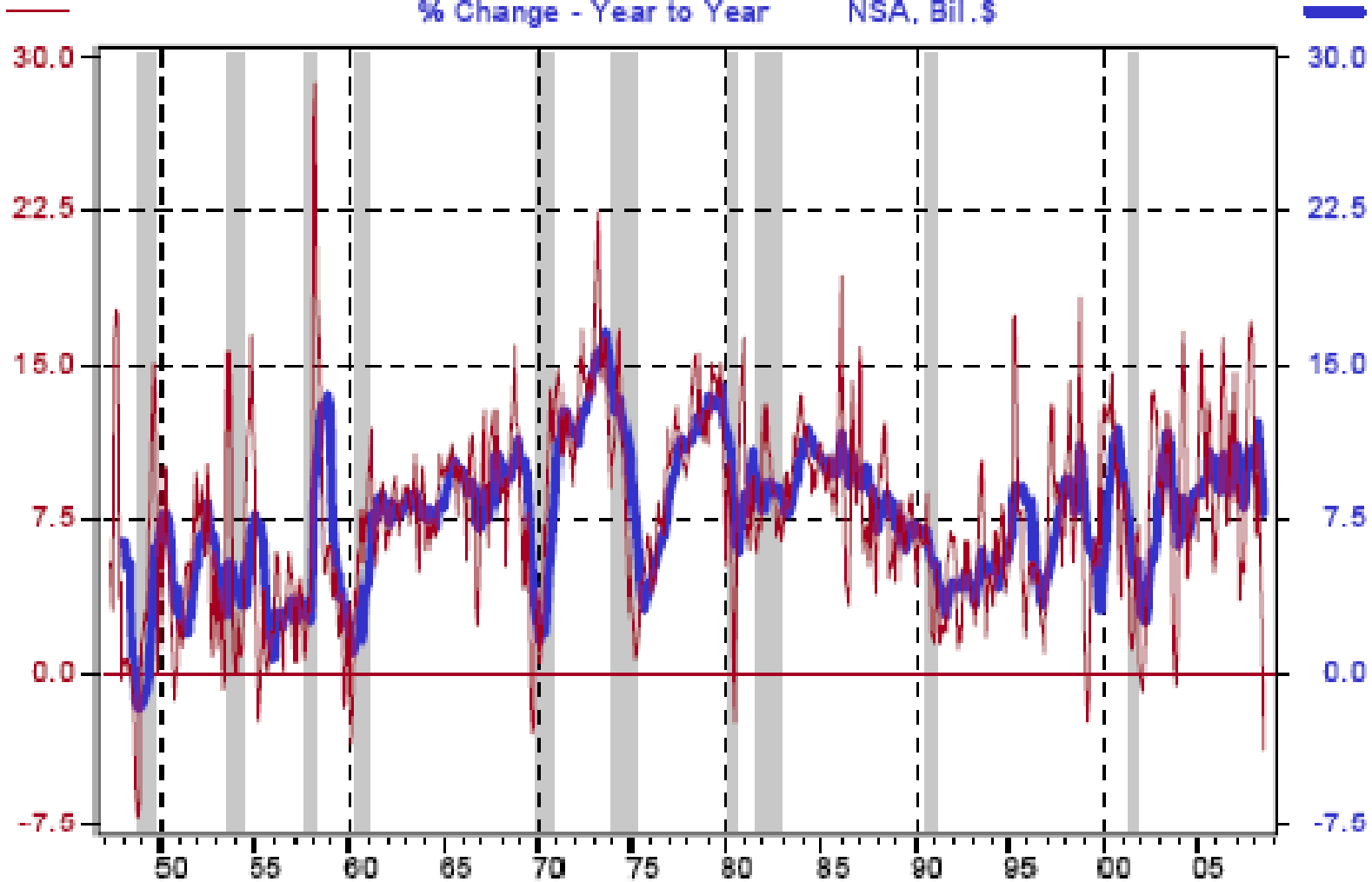


### Bank Credit: All Commercial Banks

3-month %Change-ann SA, Bil.\$

### Bank Credit: All Commercial Banks

% Change - Year to Year NSA, Bil.\$



Source: Federal Reserve Board /Haver Analytics

# Paulson's Plan will not work

- The main threats to the US economy are falling home prices and inadequate bank capital
- Falling home prices and the US recession will further increase bank losses
- Paulson's Plan will ease the process of bank balance sheet reduction but will do little to ease the banks' capital shortage problem
- The de-leveraging process must be expected to continue apace
- One must expect serious regional bank failures and troubles at the major hedge funds.

# Economic Policy Priorities for Next Administration

- Stabilize the housing market by addressing the foreclosure issue
- Articulate a policy for addressing the banks' capital problem
- Introduce a second fiscal stimulus package that is more focused on infrastructure spending
- Maintain an accommodative monetary policy stance