

What Lies Beyond the Credit Crunch? Part III

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Introduction

We began this series—actually, not thinking that it would turn into a series—in December of last year, to gather the thoughts of our learned AEI economists on how the housing meltdown would affect the rest of the economy. It seems like such a long time ago, but back then the decline in housing prices and the weakening of financial institutions was already about six months old.

The remarkable thing then, as now, was the resilience of the real economy in the face of a serious disruption of the international financial system. The turmoil among the world's financial institutions was serious even at that point. LIBOR spreads were at historically high levels and there were widespread reports that financing was not available for some activities. The international financial markets were reported as “shut down.”

In that long ago December, some of our economists predicted that the housing market was headed for an immense bust, which would cause a severe recession in the general economy. Others thought the housing decline would not be as severe, and in any case would not create much more than a mild recession.

What everyone was sure about was that, by the spring of 2008, we would have much more data and would be able to say with some confidence where the real economy was going in the wake of the housing bust. So we scheduled another conference in April, anticipating a lot more consensus.

We didn't get it. If anything, more data created more controversy. There was still a lot of uncertainty at that point about how serious the housing decline really was, and part of the controversy among the economists was what data to use. Bear Stearns had been rescued in mid-March, and the international financial system was still very fragile, but interbank lending was improving and LIBOR rates were well down from their previous highs. The U.S. economy was still not in recession. Indeed, the first quarter ended with slight growth.

Because there was still no consensus, we scheduled this conference. Again, the thought was that by October we would surely have enough data to produce some clarity. Maybe, maybe not. Financial market conditions have gotten a lot worse, but it is still not clear that the economy as a whole is yet in recession. Growth in the second quarter was somewhat over two percent. That's not good growth to be sure, but it's certainly not a recession. Unemployment is increasing, but up to now not at the rate in previous downturns. Recently, there have been

indications that consumers and business are feeling the pinch. Consumer spending is down, and manufacturing contracted substantially in August.

One thing the last 18 months has shown is that we don't have a very good idea of the linkages between the real economy and the financial markets. The financial markets are in a state not seen since the Great Depression, but the economy as a whole is certainly not in anything like that condition, and hasn't been for the 18 months that the financial markets have been in unprecedented turmoil. I don't think most economists would have thought it was possible that the financial markets could be at this level of distress without causing a serious recession, at the very least.

If the Paulson plan is rejected again, there are predictions that this will lead to financial market meltdown and a serious worldwide recession—perhaps even a depression. At this point, it's not implausible that a really serious recession could occur. There has been a huge flight to quality—to government debt—in most of the developed countries. And if the cash is in government bonds or notes rather than in banks, it is easier to see how employers might not be able to meet payrolls and companies might not be able to get the credit to meet their obligations.

Cash moves through the banking system to where it is needed, but the system depends on banks to lend to one another. By all accounts, that isn't happening. The principal reason appears to be that they are not sure of the solvency of their bank counterparties. One of the reasons for this, in my view, has been the requirement to use mark-to-market valuation of assets when there is in fact no active market.

Fortunately, the SEC now seems to be in the process of reversing itself on the application of mark-to-market accounting. Six months ago, the agency put out a letter to CFOs of public companies that said “only when actual market prices... *are not available* is it appropriate for you to use unobservable inputs ...in pricing the asset or liability.” Yesterday, in a “clarification,” they said the opposite: “When an active market for a security *does not exist*, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable.” If the SEC had said this in March, we might not be where we are today.

The Paulson plan to remove bad assets from bank balance sheets makes sense if the Treasury buys assets from the banks at a value that takes the cash flows they produce into account—as the SEC is now suggesting. This has the chance of restoring some market confidence that the banks are in fact solvent.

For purposes of this conference today, our economists might assume the Paulson plan is adopted or that it is not. They can also assume that if it's adopted, it just makes things worse. Whatever they assume, I'm looking forward, like you, to hearing where they think the real economy is going in the months ahead.