The Credit Crisis: Final Act or Intermission?

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We have reached a particularly difficult stage in the development of the credit crisis. There are two quite different views of where we're at. One is that the worst is now over. The other is, to invoke the old song, that "we've only just begun" – that we're in for several more quarters of serious credit problems.

I should acknowledge that as a resident of California my views are shaped by what I see unfolding in the United States, and specifically in the Western United States. But it is clear that what happens in the United States will be critically important as well for the UK and, more generally, for Europe. Everyone talks about America's declining economic and financial power. But when it comes to credit markets at least, the U.S. is still the tail that wags the dog.

On the one hand, there is a growing school which holds that the worst is over. In this view the rescue of Bear Stearns by the Federal Reserve in March and the Bank of England's just-announced Special Liquidity Scheme mark an important break; they have put the worst behind us. Say what you will about the downside of the Bear Stearns rescue, and there *is* a downside, the Fed's success at orchestrating that rescue, not unlike the rescue of Northern Rock, demonstrated once and for all that the authorities are not prepared to allow the failure of a systemically-connected financial institution. The Bank of England's just-announced Special Liquidity Scheme, together with various initiatives by the Fed to accept as collateral a widening array of mortgage-related securities, notably its $200 billion Term Security Lending Facility, indicates a resolve to get credit directly into the impacted markets. Banks have disclosed more information about their losses and marked down their subprime-related exposures. With the bad news now out there, markets have presumably hit bottom and are poised to rebound. Banks in the U.S. are successfully recapitalizing themselves. Washington Mutual has raised $7 billion of new capital from a private equity firm, TPG. National City has raised another $7 billion from another private equity firm, Corsair Capital.

All this explains the improved performance of Wall Street. It explains why government bond markets have been falling, as investors who had previously scrambled into government bonds as a safe haven are now returning to other credits It explains why Japanese bond markets just suffered their biggest one-day route in five years. (You may have noticed that the collapse in Tokyo last Friday was so severe that trading was halted for 15 minutes, the first time this had happened in the market's history.) It is explains why U.S. two year treasury notes just experienced their largest two-week fall since 2001. This final bout of volatility is seen as evidence of the markets beginning to normalize.

The other view is that the crisis is far from over – that in fact we have only reached the intermission. The first act was precipitated by the slump in the U.S. housing market following its peak in the summer of 2006 and the subsequent losses on subprime mortgages that reached a crescendo in the summer of 2007. Aggressive steps by central banks and regulators prevented those events from destabilizing the global financial system, but they did not prevent the housing slump and associated credit problems from plunging the United States into recession. Credit problems and the souring growth outlook have led firms to cut back on investment spending. Falling house prices have eroded consumer confidence and prevented U.S. households from using their homes as ATM machines. Consumer confidence in the United States is at a 26 year low. With both consumption demand and investment demand now weak, export demand is the only component of aggregate demand left to the United States. So the fact that the Fed's interest rate cuts have had the effect of pushing down the dollar is actually a good thing from this point of view.

Unfortunately, those interest rate cuts, by adding fuel to the commodity-price fire, have further damaged consumer confidence. The main topic of conversation in the United States in the last week has not been the race for the Democratic presidential nomination but the prices of gasoline and rice. In California, where we have a large Asian-American population, there has been a run on 20 pound bags of rice at Sam's Club that puts the depositor run on Northern Rock to shame. Insofar as interest rate cuts are responsible for the behavior of commodity prices, there is the feeling that they have gone far enough.

Similarly, there are worries that the decline in the dollar has reached the point where its fall is damaging confidence more than it is supporting demand. Thus, early champions of Fed interest-rate cuts, like the Harvard professor Martin Feldstein, now argue that further cuts and further dollar declines would be undesirable. The bottom line is that the Fed has gone just about as far as it can in using interest rates to limit the severity of the recession.

And limiting the severity of a recession is not the same as averting a recession. It is clear that a U.S. recession is underway. In addition to the developments cited above, there is a 9 month inventory of unsold homes to be worked off. Add many as 10 million homes where the owners, under water, just walk away – those houses are going to have to be sold as well – and it could be 2010 before the all-important U.S. residential construction sector begins to recover. Without a residential construction recovery, there isn't going to be robust economic growth. I can't predict the depth of the recession. No economist reliably can. But I can confidently predict that this recession will be a long one – longer, certainly, than two quarters. Such is the nature of housing-market-driven recessions.

That, in turn, is why there will be more credit-market problems. The first wave of problems was centered in markets for repackaged residential mortgages. The next one will be centered in markets for securities backed by commercial real estate and corporate receivables, as the commercial real estate and corporate sectors feel the brunt of the recession. As corporate and commercial borrowers default on their loans, there will be more bad news from the banks. (Recall that corporate default rates in the U.S. spike up to 10 per cent in the typical recession – they were below 1 per cent last year – and this may not be a typical recession.) In these circumstances, banks will be reluctant to extend credit to corporate borrowers. They will be reluctant to extend credit to one another, not knowing who is at risk from loans to commercial real estate and manufacturing firms. This is evident in the recent behavior of the Ted Spread, the spread of three-month interbank interest rates over the yield on 90 day U.S. Treasuries. Ted has been rising again as bad economic news has hit the papers. It is back up to pre-Bear Stearns levels. I am familiar with the controversy over the accuracy of LIBOR, but that's a second-order issue from the present point of view. The fact that we are essentially back to pre-Bear Stearns levels is a clear sign that the credit crisis is far from over.

Just in case you still have any doubt, it is this second view that is mine.

What does this imply for the dollar? It is incompatible with the view, which one hears now with growing frequency, that the dollar has fallen so far that it has to recover. If the U.S. is in for a long recession and serious credit problems are not over, then betting on dollar recovery would be premature. The problem is that the dollar has fallen dramatically against the euro but much less against the Asian currencies, because of the reluctance of governments and central banks there to let their currencies move against the greenback. It would be nice if those Asian governments and central banks let their currencies strengthen more against the dollar – both to make up lost ground and because Asia is the one part of the world that is growing strongly. The dollar could then recover a bit against the euro, which would take some pressure off of Europe, without appreciating on an effective basis. Indeed, if exchange rates were simply left to the markets, I would not be surprised to see the dollar fall further on an effective basis, given the weakness of the U.S. economy. That is, any recovery against the euro could be dominated by further depreciation against Asian currencies.

But the reality is that exchange rates are not left to the markets. With inflation accelerating, Asian central banks are likely to countenance a bit more local-currency appreciation against the dollar, but only a bit. And if they limit the depreciation of the dollar against their currencies, there is not going to be much recovery of the dollar against the euro.

This leaves me pessimistic about Europe. A long recession with more credit problems in the United States will not be good for the European economy. If the euro stays as strong as it is currently against the dollar, then German export growth, which has been pulling the German economy and therefore the European economy along behind it, will peter out. The IMF has recently come under fire, from Germany in particular, for its pessimistic forecasts of European growth. It sees European growth slowing from 2.8 per cent in 2007 to 1.5 per cent in 2008. My view is that the Fund remains, if anything, overly optimistic.