The Credit Crisis

Limited Assets and Unlimited Liabilities

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The Ticking Sound

• We started to hear this ticking sound last summer (actually last spring)
• Alarm clock?
• Time-bomb?
• Initially we hoped it was coming from an alarm clock
• Unfortunately, it is clear that it was a time-bomb
This one is different

- It doesn’t look like this is a garden variety cyclical recession
  - We experienced only two of those in the last 25 years, both of which were shallow and short
- This is a recession induced by the bursting of a bubble
  - This is the second bubble burst in 7 years
- The effects of the housing bubble burst are much more severe than the dot-com burst
- The dot-com burst affected primarily business capital spending – which constitutes 10-12% of GDP
- This one is felt in consumption and construction – which accounts for 78% of the GDP (consumption alone is over 70% of the GDP)
What caused these bubbles?

• The Fed may be partially responsible
  – Russian default, LTCM, internet shocks
• The policy of fighting financial shocks by injecting liquidity does not appear to protect the real sector in the long-run
• It just postpones and lays the groundwork for future and *bigger* bubbles
• Accommodative monetary policy may create a moral hazard problem
How do we know the two episodes were indeed bubbles?

- **NASDAQ**
  - November 1998: 1900
  - December 1999: 4700
  - March 2001: 1800

- **Value of U.S. Residential Property**
  - End of 1990: $8 trillion
  - End of 2006: $20 trillion
Why promiscuous monetary policy did not create the usual effect (inflation)?

• The world reaped the benefits of globalization
• Productivity gains during the last decade were very high (2.6% per year) compared to the previous decade (1.6%)
• Recent productivity gains are much less
• Thus, these two-supply increasing developments
  – Prevented increases in goods & services prices
  – Instead created “inflation” in asset values
    • First, in financial assets (dot-com)
    • Later in real assets (housing)
Who is to blame for the current crisis?

- The problem is so big that there is plenty of blame to go around
- The panelists will discuss these…
  - Financial innovation (alphabet-soup of financial products)?
  - The principal-agent problem inherent in securitization?
  - All of the above and then some?
Naming the crisis

- Initial name “liquidity crisis” is way off-the mark
- The world was flush with liquidity. In fact, it was the presence of *excess* liquidity and not *shortage* of liquidity that contributed to the crisis
- A more accurate name would have been the “under-pricing of risk crisis”
- But now this has morphed into a “confidence crisis”
- We have the flip side of the phrase coined by Greenspan:
  - Instead of “Irrational exuberance”
  - The mood now is
    - “Irrational despondency”
Why was risk mispriced?

• When lots of funds chase investments
  – Asset prices go-up, returns fall
• There are two “easy” ways of getting higher returns
  – By assuming more and more risk without demanding adequate compensation
  – By using higher and higher leverage to magnify returns
• Use of Leverage was not confined to hedge funds, etc.
• Due to ever increasing housing prices and the irrational expectation that this will continue
• Household debt as a percent of disposable income:
  – 1970: 60%
  – 2000: 100%
  – 2006: 130%
Wise men’s take

• Soros:
  – The worst crisis in the last 60 years
  – Blames the Fed for preventing markets from punishing the guilty parties for their excesses

• Warren Buffet:
  – “As housing prices fall, a huge amount of financial folly is being exposed”
  – He also expressed this more colorfully:
    • “You learn who has been swimming naked when the tide goes out”
Data paints an ugly picture

- Mortgage/credit related losses alone so far is estimated to be over $480B
- A study estimates that these losses alone will shave off 1.3% from this year’s GDP growth
- 5.82% of the mortgages are at least 30 days delinquent (4th qtr, 2007)
  - The highest figure since 1985
- 1.8 million mortgages are in default
- 20% of the sub-prime adjustable-rate mortgages were past due (4th qtr)
  - An additional 13% of them are in foreclosure
The Sub-prime spread

• Mortgage market problems spilled into
  – Credit card loans (even at AMEX)
  – Car loans
  – Home-equity loans
  – Leveraged loans (LBO debt is now toxic)
  – Commercial property loans
  – Mono-line insurers

• Large investment funds including one affiliated with Carlyle group which has a $21.7B portfolio (how do they know?) is about to collapse
  – The fund has a fitting trading symbol: CCC
Housing prices

- Housing prices fell 11.7% (January (2007-2008))
  - Represents a loss in home-equity based wealth of $2.4 trillion
- The fall in housing prices during the last 3 months is 20% at an annualized rate
Stock Prices

• For the quarter: Dow-Jones is down 7.6%
• S&P 500 is down 8.1%
• NASDAQ is down 14%
• Analyst expect earnings of S&P firms to be down 8.1% for the quarter
• Earnings of financial firms are expected to have dropped 49% during the 1st quarter
• And forecast another 30% drop in the 2nd quarter
Additional Financial Data

- 7% of all mortgages have Loan-to-value ratio in excess of 100%
- S&P downgraded or threatened to do so 8000 mortgage-debt securities last quarter
- During the last week of February 2007, fire sale of Muni-bonds sent the spread between these and Treasuries to an historic high
  - In fact, on March 1st, 30-year AAA Muni bond had a yield of 5.14% vs. 30-year Treasury yield of 4.42%
  - Last I checked, unlike Muni’s Treasuries were taxable
The Fed has done a lot

- Cut the fed-funds rate 6 times since September from 5.25% to 2.25%
- Fed and ECB injected a combined $880B
- Made discount window borrowing available to Investment Banks
- Accepted low quality collateral
- Even arranged a shot-gun wedding (JPM-BSC)
- Congress passed a $140B stimulus package (1% of the GDP)
- Capital requirements at Fannie and Freddie are eased
And yet…

• 70% of economists in a WSJ survey (conducted March 7th-11th) think we are in a recession
• Consumer confidence index plummeted 11.9 points to 64.5 in March
  – Lowest level since the start of the Iraq war in 2003
• Consumer expectations about the future plunged to their lowest level in 35 years (oil-embargo days of 1973)
• Inflation expectations for next year increased to 6.1% (in March) vs. 5.4% (February)
• Unemployment report of this week is expected to show a rise to 5% (from 4.8%)
  – Third straight monthly contraction in labor markets
More bad news

• In spite of all the rate cuts
  – 30-year mortgage rates are around 5.9%
  – LIBOR rate rose to 4.47% on Friday
    • Its highest level since December
  – Risk spreads remain high
    • E.g., Treasury & Fannie guaranteed mortgage bonds are about 1.8%
      – Lower than the beginning of March, but still higher than a year ago
Some food for thought

• Isn’t Fed running out of pages in its playbook?
  – Doesn’t it have one less bullet in the chamber with each shot fired?
• Should the Fed have an activist stance towards every financial shock?
• Can the problems created from excess liquidity be solved by injecting even more liquidity?
• Do Fed’s actions create a moral hazard problem?
• What will be the future cost of this immense liquidity injection? Inflation?
Finally…

- Are traditional monetary/fiscal responses enough to solve the current confidence crisis?
- What regulatory/other measures need to be taken?
- Given the connected nature of global markets (both capital and goods markets), is it likely that we will experience more frequent and perhaps even deeper shocks in the future?
- How can future toxic asset bubbles be avoided?
- Where do we go from here?
Where do we go from here?

• What needs to be done to solve the current “confidence crisis”?
• How should the current regulatory environment be restructured?
• How does regulation keep-up with future financial innovations?
• What can be done to minimize the frequency/size of future financial shocks?
• Should the Fed have an activist policy stance towards intermittent shocks?