WHERE ARE WE IN THE CRISIS AND WHAT TO EXPECT NEXT?

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1. Introduction

From the mid-1990s until 2007 the world economy lived through a long asset-price-driven boom. Ever-rising levels of liquidity increased the search for return and steadily lowered risk aversion over time. In the US, a new shadow credit system came into existence, eclipsing the role of traditional banking in the credit creation process. New financial instruments proliferated and were absorbed with rapidly increasing levels of leverage, raising the financial system's capacity to finance ever larger quantities of long-term illiquid assets with short-term liabilities. But, that meant that levels of financial fragility in the system also rose steadily, exposing many of the world's largest financial institutions to increased risk of a recession. When finally risk aversion returned and investors pulled back, a self-reinforcing cycle of deleveraging forced a mass liquidation of assets, shaking the system to its very core.

The financial crisis that began with the subprime debacle in August, 2007, has undoubtedly been the most serious crisis of its kind since the Great Depression. Many financial institutions on both sides of the Atlantic have been hit harder than anyone ever thought possible, forced to write off billions of dollars in bad credit and raise large amounts of new capital to remain solvent. Yet, despite the relative semblance of financial calm restored since the dramatic rescue of Bear Stearns by the Federal Reserve in March, banks might not have seen the worst of it yet. In the US, housing prices continue to fall, signs of recession multiply and rising inflation threatens to take the wind out of central banks' sails in their fight against the crisis. Just as the fallout from the housing bust and credit crunch is weakening final demand, the sharp run-up in prices of oil, food and commodities is raising inflation and beginning to cause an uptick in inflationary expectations as well. Thus, stagflation might once again push central banks up against a wall. Already getting blamed for letting the beast slip out of its cage by lowering interest rates too much in the US, it is likely that the Fed will find itself under increasing pressure to tighten in the face of rising oil prices, the weak dollar and, above all, a European Central Bank that is more nervous about inflation than the Fed itself.

Falling home prices and illiquid securitized assets have been the two crucial hallmarks of the present crisis. Both are but a legacy of a credit system that financial liberalization and deregulation brought about, a system that is now in the process of unraveling. How this system worked and why it collapsed when it did hold the key for what needs to be done to contain the complex contractionary dynamics the crisis has unleashed. Much of the following discussion is oriented towards the US—admittedly because that is what the author is more familiar with—but also because, arguably, what happens there is likely to be more decisive in terms of its impact on the world economy than what happens in any other single region or country. The discussion turns next to the credit system that emerged under financial liberalization in Section II below and is followed by an examination of the US policy response to the crisis in Section III and how that policy package is now being threatened by rising inflation in Section IV. The paper ends with a few concluding remarks.

2. Financial liberalization and the rise of the shadow credit system

It is well known that since financial deregulation, commercial banks lost many of their advantages in attracting savings and were forced to innovate, transforming the role banking played in money and credit creation mechanisms along the way. Not only have commercial and industrial loans decreased in importance in the overall credit supply in the economy, but their relative importance in banks' total assets has experienced a steady decline as well. Traditional banking, as a result, has ceased to be central to credit creation as it once was before the era of financial liberalization (Ozgur and Ertürk, 2008).

By the late 1980s, liability management had acquired a level of importance unimaginable just a few years earlier with the emergence of certificates of deposit, increased access to the federal funds markets and use of credit market instruments. Whatever constraint deposits might still have imposed on bank credit was further relaxed by the drastic easing of reserve requirements by the mid-1990s. The Fed had abolished reserve requirements for time deposit accounts and reduced them for checkable deposits in 1992, and later, in 1994, retail sweep accounts were introduced, after which required reserves for all intents and purposes ceased to be an issue. This made it possible for banks to manage their assets with a level of discretion that was unprecedented. Finally, with asset securitization, eased by the shift of lending towards loans collateralized by real estate in part because of Basel I, new layers of intermediation emerged, expanded and multiplied, all unreflected in banks' balance sheets so that constraints imposed by their capital base could now be sidestepped. Thus, in this new system, banks have acquired almost total independence from required reserves and core deposits, while the kind of asset maneuverability securitization provided helped them circumvent the constraints posed by their capital base (Samolyk, 2004). When they lacked enough capital to put loans on their balance sheets, they went on to create off-balance sheet vehicles—often called "securitized investment vehicles" (VICs)—to carry them anyway, giving rise to an explosive increase in credit in the economy as a whole. The VICs, subsidiaries of the banks that set them up in everything but the name, worked like investment trust. (Kregel, 2007)[1].

Banks would make mortgages only to offload them onto these off-balance sheet entities, generating their income not from holding assets with an interest rate spread but originating and moving them for a fee just like a broker would. The vehicle, in turn, issued liabilities and used the proceeds to buy the assets (mostly mortgages) the banks did not want to keep on their balance sheets. Using them as collateral to issue more liabilities of its own, it grouped these assets into different batches, called tranches, to generate some desired earning stream and risk combination. The liabilities issued against the "senior" tranche received the lion's share of income at lowest risk and were given the investment grade by the rating agencies for being "overcollateralized," making them palatable to all institutional investors. The income that was left after what the senior tranche received then went to the residual tranche, which got a lower grade and the liabilities issued against it were sold to those with lower levels of risk aversion such as hedge funds. Over time, residual tranches would themselves be regrouped to generate their own "overcollateralized" senior tranches and be insured—either implicitly by the sponsoring banks by means of some buyback guarantee or explicitly by some credit default swap written by the monolines or some other financial institution—to increase their attractiveness to investors (Engdahl, 2008; Kregel, 2007). The organizing principle of the whole idea, that any credit risk of the assets in the structure could be compensated by overcollateralization of the collateralized obligation itself, soon began to work like a Ponzi scheme—seemingly palatable CDOs could be issued ad infinitum from increasingly riskier assets as long as a larger pool of even riskier assets could be found. Self-fulfilling asset-price expectations were the driving force behind the scheme. As long as home prices kept rising, capital gain expectations made it easier for banks to push mortgages on increasingly higher risk households and the credit increase that resulted from it fueled demand and thus the increase in home prices.

But, once investors started to pull back and deleveraging began, these assets found their way back in one way or another to banks' balance sheets en masse, threatening the very integrity of the banking system. As a result, policy response understandably aimed at preventing distress sales of classes of assets for which market liquidity had dried up and mitigating the downward pressure on home prices from deleveraging.

3. Policy response to the crisis in the US

The overall US policy response to the financial crisis simultaneously targeted (I) banks and the credit system,

[1]The Gramm-Leach-Bliley Bank Reform Act, enacted in 1999, expanded the scope of capital market activities allowed for commercial banks, permitting them to own subsidiaries that could engage in the type of financial activities they could not.

(II) the housing market and (III) final demand, where the effectiveness of one component rested on and bolstered that of the other. The first component was based on—in addition to lower rates—enabling banks to borrow against collateral of dubious market value all the while helping and urging them to recapitalize; the second involved direct and indirect use of public funds to buy off shaky mortgages; while the third relied on both fiscal and monetary easing to counteract the negative shock on aggregate demand.

The main challenge the Fed faced in the credit market was to prevent a panic-driven distress sale of assets—definitely by commercial banks on top of the credit hierarchy, but also, preferably, by all players at lower layers of the system as well—that could cascade into a financial meltdown. But, as the crisis hit, it became clear that the Fed's traditional instruments of control over depository institutions were quite useless in fighting a major disruption in the credit system of the new era. First, the Fed could not track the credit flow and the leveraging that had built up—its monitoring ability was impaired by the new opaque and circuitous layers of financial intermediation that emerged outside banks. Thus, no one really knew where—and how many— bad apples were in the barrel. Second, much of the credit supply in the past originated from banks, and thus any liquidity shortages that threatened the supply of credit could be dealt with relatively easily by injecting liquidity directly to banks—the primary dealers in government securities. As discussed in the previous section, financial intermediation had been transformed—not only had banks sold many of their loans to others; much lending originated with nonbank institutions in the first place. Thus, even though the Fed stood ready to bail out banks directly by providing credit as needed, it was not easy to get them to rescue nonbank firms when the latter ran into trouble meeting margin calls from the banks. At the bottom of the food chain were many nonbank institutions that were deemed to possess portfolios of securities whose underlying mortgages were sound. But, when the crisis hit, loss of confidence drastically reduced the willingness to hold even the sound securitized assets, obliterating much of their value. Falling prices of securities eviscerated the collateral of many such institutions, triggering margin calls from banks. Failing to meet them threatened distress sales of assets and yet more margin calls and yet another bout of decreases in asset prices until the whole system faced collapse.

Finally, in the dramatic Bear Stearns rescue in March—we will probably never know how close the system came to a meltdown—the Fed bent rules in a desperate dash to make liquidity "directly" available to a nondepository institution. Prior to the Bear Stearns rescue, the Fed's brand-new facilities to auction liquidity—the Term Action Facility (TAF) and Term Securities Lending Facility (TSLF), accessible respectively to depository institutions and primary dealers only (Bernanke, 2008)—had broadened the types of securities it accepted as collateral, but not the types of institutions that could take part in these auctions. Clearly, that was not enough; something more had to be done.

In the market a large swath of mortgage-backed securities had become next to worthless even though the underlying mortgages over which they represented claims were still performing and the Fed was finding it hard going to prod banks to stake a position in them. Bank or nonbank, private firms were balking at a profit opportunity, ostensibly because they could not tell if the sound mortgages would also rapidly deteriorate as the slump deepened. Something had to be done to carve out the good assets from the bad before contagion from what was going on in the financial side harmed them. In a nutshell, this was the problem that needed to be addressed. One strategy was to have the Fed act not only as the lender of last resort but also as the "market maker of last resort" in the hope that market evaluation would return to normalcy as panic subsided. Thus, letting nonbank institutions use the Fed's TAF would have been a step in this direction. The more drastic alternative was, of course, some form of socialization—the use of public funds directly or indirectly to buy outright either the securities or the underlying mortgages. The latter was the course taken in the US while the Europeans appear to have opted for the former. In the US, the government-sponsored enterprises (GSE) Fannie Mae and Freddie Mac, along with Federal Home Loan Banks, were directed to purchase and securitize home mortgages and refinance subprime mortgages. Likewise, Federal Housing Administration (FHA) guarantees to refinance subprime mortgages were expanded, with legislation pending to ease payment requirements on guaranteed loans and raise FHA loan limits.

We still do not know what exact institutional configuration will emerge at the end as the political process is still unfolding and is likely to be in flux for some time. Though chartered by Congress, GSEs are nominally private companies, and that tends to obscure what really has been taking place. However, it will not be surprising if GSEs require an infusion of public funds themselves pretty soon—they have come under severe financial strain as their market share has ballooned since last year. In any event, proposed legislation is now in Congress which aims at establishing a new federal corporation similar to what was put in place in the 1930s to use public money to purchase distressed mortgages directly without any intermediaries such as the GSEs (Wheelock, 2008). Otherwise, one might expect that it will only be a matter of time before it is generally recognized that much of the mortgage market in the US has already been socialized.

But, be that as it may, banks' losses can mount again if house prices fall another 20 percent.[2] Although public control or, better yet, ownership of home mortgages will no doubt give greater flexibility in preventing or slowing down foreclosures, no one can tell what effect an additional 20 percent fall in house prices could have. If bankruptcies by firms and households begin to increase in the near future as expected, how much banks will have recapitalized and thus won't have to curtail credit is still the big unknown that will be decisive in how much deeper the slump will get. US corporate profits have been falling for the last four quarters, unemployment is on the rise and personal income is stagnant or falling. Thus, clearly demand stimulus could play a very helpful if not decisive role in the period ahead of us. But now stagflation is a threat both to demand management and to what has been achieved so far. Higher rates, if the Fed is forced to reverse course as the market now expects, will only worsen conditions in the housing market and increase bankruptcies, making it harder to keep the pieces glued together in the credit system. If banks falter again, that will make contraction of demand all the more severe and a downward spiral will ensue. The threat of a deep and long lasting recession is not over.

4. Will the Fed reverse course?

After few months of relatively small increases, the producer price index for finished goods jumped 7.2 percent in May over the past year, while the increase in the core index was 3.4 percent. Clearly, if this continues—difficult to think it would not with oil remaining around $140 a barrel—what can the Fed do but raise rates? The sanguine view holds that strong growth in large emerging economies like China and India is what is primarily behind the price inflation, and whatever supply problems Nigeria, Mexico and other oil exporters are facing hardly amount to the kind of supply shock the world lived through in the 1970s. Likewise, unlike during the 1970s, workers today are not strong enough to protect themselves against price increases, and, in any case, rising unemployment stipulates against real wage pressure. Also, if "decoupling" is not going to happen, as everyone now seems to agree, emerging economies are bound to slow down as the US recession deepens. So, barring a new political adventure in Iran the Bush administration might bequeath the world on its way out, this means that the high oil and commodity prices will soon moderate and if they don't, that will be a blessing in disguise as it will mean that the worst is averted.

But, then, it is disconcerting that future prices of oil have been steadily rising just as the signs that the US recession will not be short-lived are becoming stronger. This seems to point at another explanation for rising global inflation that is much less sanguine because it involves falling confidence in the dollar as the world reserve currency. In a nutshell, the effectiveness of the expansionary fiscal stance and monetary easing in the US is predicated not only upon foreigners holding onto their dollar reserves but also upon their willingness to keep accumulating them. While they do not seem to be diversifying out of their dollar reserves in droves, they seem to be losing their appetites for accumulating more at a faster clip.

[2]The latest figures of the Case-Schiller index show that housing prices have fallen more than 16 percent from their 2006 peak (FT, 5/28/08). In an August, 2005, interview, Robert Schiller predicted that US housing prices could fall by 40 percent (Leonhardt, 2005).

Looked at from this point of view, the emergence of commodities as a new asset class—and rapid growth of investment in them by hedge funds, pension funds and sovereign wealth funds along with investment banks—is but a sign of the increasing flight from the dollar. Much of the usual focus on the dollar peg in the so-called dollar-zone countries in Bretton II thus misses the fundamental point about dollar-denominated financial assets losing their effectiveness in mopping up the excess liquidity the US is continuing to create in the world economy. When a reserve currency begins to cease to function as a reserve currency, reserves—whether of countries that peg their currencies or not—fail to function as a sink for whatever excess money increase there is. Thus, in the absence of such a sink, the larger dollar reserves the increasing supply of dollars gives rise to around the world raise the domestic money supply in the countries where they are accumulating and bid up the prices of oil and commodities overseas, only to return to the US like a ping pong ball in the form of higher-priced imports. That these countries peg their currencies to the dollar matters little. If they did not, the inflationary shock and thus the pressure to raise rates in the US would only be stronger. If one were to think of a one-liner to summarize it all, it would go something like this: Output can be increased steadily by raising the money supply with a currency that enjoys the full confidence of agents in an economy, but if overdoing it eventually busts the currency it will cause inflation.

Conclusion

The Fed today is probably right where it ought to be if the former view holds true. It successfully averted a financial meltdown by acting decisively and boldly just at the right time and helped mitigate the negative demand shock by keeping interest rates low by just the right amount. Signs of rising inflation should not cause it to panic into raising rates hastily, which can create great harm in the real economy. Instead, shaping market expectations by speaking to the problem as it has already begun to do is the right approach to take. Likewise, the weak dollar can be finessed higher by better coordination with the Treasury even if the Europeans do not cooperate much. The prognosis is bleaker, however, if the latter view on inflation is true. In this scenario, keeping rates lower is not going to be much of an option because inflation and flight from the dollar will dynamically feed on each other and keep getting worse. But, raising rates will not necessarily fix the problem either because it will risk worsening the housing bust, hastening bankruptcies and thus deepening the slump. The financial system then will come under strain again, in all likelihood at a time of increased exchange rate volatility that will make a dollar overhang a much more serious threat. If that happens, let's hope it will not be too late to give a chance to Fred Bergsten's insightful suggestion (Bergsten, 2007) about the creation of a substitution account at the IMF through which unwanted dollars can be converted into special drawing rights.

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