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Denial, Hope, and Panic

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In October 1907, J. P. Morgan stemmed a financial panic by coercing other banks to join him in providing credit to Wall Street brokerage firms teetering on the edge of bankruptcy.[1] This year, over the weekend including March 15—the ominous Ides of March—James Dimon, head of JPMorgan Chase, was the one to act. With the Federal Reserve squarely behind him and assuming the risk, he prevented a Bear Stearns bankruptcy by agreeing to purchase the firm, providing it with a decent burial, at a price of $2 per share. Bear Stearns's stock had been valued at over $160 per share just a year ago. The $2 price virtually wiped out the value of that stock, one-third of which is owned by its 14,000 employees. This was clearly not a bailout for Bear Stearns shareholders, and whether or not the steps taken by the Fed on March 16 were sufficient to arrest a further collapse of available credit and the economy remains to be seen. As long as house prices keep falling, the underlying problem for credit markets and the economy remains.

Bear Stearns—Again

The Bear Stearns "rescue," as it has been described by some, is hardly that. The collapse of two of Bear Stearns's highly leveraged mortgage funds in June 2007 was a signal of underlying problems in credit markets that surfaced system-wide in August as a "subprime" problem only. The trouble has spread rapidly to the entire credit market. The Fed's dramatic intervention on Sunday evening, March 16, to avoid a systemic panic tied to an outright collapse of Bear Stearns was played strictly according to the rulebook. When a risk-taking financial institution is threatened with bankruptcy, shareholders should take the hit. Counterparties, the investment-banking equivalent of depositors in commercial banks, should be protected. So it was in this case. The Federal Reserve took $30 billion of weak Bear Stearns assets, whose face value was far higher, onto its balance sheet and assumed any risk of further loss of value associated with that step. Meanwhile, the Fed committed to lend to commercial and investment banks another $400 billion—the uncommitted portion of its $800 billion balance sheet. This was an unprecedented step, roughly equivalent to the use of emergency Fed powers not employed since the Great Depression.

Rush into Cash and Near-Cash

It is important to understand that the Fed has not yet taken the radical step of trying to address the crisis by printing more money. In fact, as long as the Fed is committed to pegging a federal funds rate, any liquidity it provides to banks and investment houses by swapping mortgage loans of questionable value for the safety of Treasury securities does not produce an outright increase in the quantity of money. Rather, such a move is an attempt to increase the quantity of available credit by lending Treasury securities to commercial and investment banks for a fixed period of time (up to ninety days under the March 16 arrangement) in an effort to ensure the ability of those banks to meet the increasing demand for

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credit. This is happening at a time when the risks tied to providing credit, especially real estate credit, are perceived as very high. When everyone is scrambling to swap mortgage loans for Treasury securities in a great rush to reverse the risk-seeking behavior—greed, to be more blunt—of the 2003–2006 period, the Fed is trying to oblige by swapping hundreds of billions of its Treasury holdings for mortgages held by banks and investment banks. Still, with yields on three-month Treasury bills hovering around 70 basis points (almost zero), the distinction between bills and cash is almost gone.

If the fed funds rate goes below 1 percent, we are perilously close to needing to print money, and so the Fed is highly cognizant of taking that step only as a last resort.

In the "rush to cash" environment, banks that have agreed to supply credit to nervous corporations and individuals are reluctant to do so at a time when the demand for that credit is greatest. As corporations draw prearranged credit lines, reluctant banks find their ability to make loans to households impaired, given their desire to reduce overall exposure to anything but the least risky loans. Consequently, banks have begun aggressively to rein in credit lines to households, reducing home equity lines and requiring much more stringent terms on mortgage refinancings. Discretionary loans are available only to prime credit risks—those who do not need them.

Monetization

The rising pressure on the Fed to monetize (that is, to move to outright printing of money) has been telegraphed by the rush of households, business firms, and Wall Street into Treasury securities. For households, the demand for absolute safety of Treasuries is so intense that money-market funds like Vanguard have refused additional deposits into their Treasury-only accounts. Merrill Lynch and some other money-market funds are charging 1.5 percent per year for access to their money markets and paying only 1 percent—or less—to the investors who still want more.

If investors want more Treasury securities than the Fed can provide from its balance sheet, it will be forced to provide non–interest bearing U.S. government securities or cash. Already, the Fed has expended $400 billion of the $800 billion in Treasury securities it has on its own balance sheet to satisfy the surge in demand for absolutely safe assets in a highly uncertain financial and economic environment.

The arranged sale of Bear Stearns was an attempt to quell the rush into Treasuries and cash by assuring commercial and investment banks, and thereby their depositors or creditors, that a virtually unlimited supply of safe assets (Treasury bills and cash) would be available if needed. This is the equivalent of the way to stop a run on a bank. If everyone goes to the bank and asks to withdraw cash, and all succeed, the run is over. If anyone who goes to the bank finds that no cash is available, however, the run spreads and intensifies. The Bear Stearns sale assured the firm's counterparties that if they wanted their cash out of Bear, the Fed would make it available. The question remains whether nervous financial market professionals will want to get their cash out of other investment banks and whether nervous households will continue moving cash out of commercial banks and into Treasury securities.

The Fed's desire to avoid printing money outright is understandable. If the demand for cash gets so large that the Fed is forced to print money to satisfy a surge into cash, it will lose control of the level of the federal funds rate. If banks, investment banks, and households need $800 billion or more of cash in order to find a safe place to store wealth in these uncertain times, the ability of the Federal Reserve to offset the cash infusion will be overwhelmed. Consequently, the federal funds rate, currently at 2.25 percent, will go to zero.

No central bank—least of all one headed by Ben Bernanke, a distinguished scholar on lessons of the Great Depression—wants to reach a point where a zero fed funds rate is not low enough, since that forces the outright printing of money to accommodate depositors and counterparties who want only cash. Before we get to that point, the Fed has two more instruments it can use: direct purchases of mortgage-backed securities to put a floor on their value and further cuts in the fed funds rate, at least to 1 percent. If the fed funds rate goes below 1 percent, we are perilously close to needing to print money, and so the Fed is highly cognizant of taking that step only as a last resort. That concern, along with inflation fears expressed by two dissenting members of the rate-setting Open Market Committee, who preferred a smaller reduction, may explain why the committee cut the fed funds rate by 75 basis points after its March 18 meeting. This was less than the full percentage point that had been expected.

The Underlying Problems

A crisis in financial markets is a reflection of a crisis in the underlying real economy. The long period of denial from Wall Street and the Fed that the economy was heading into recession undercut the perceived need to take proactive measures to deal with rising problems in the credit markets. The highly respected economics team at JPMorgan was predicting no U.S. recession until the appearance, on March 7, of February employment data that confirmed the onset of a sharp drop in private sector employment. Over the three months ending in February, private sector employment fell by 141,000, and the year-over-year growth rate of overall employment fell to 0.6 percent—well below the 1 percent rate that has, in the past, heralded entry into a recession.

The roots of the problem remain the relentless fall in house prices and the associated credit problems it creates. During February, the Case-Shiller House Price Index indicated that the drop in house prices had accelerated to a 9.1 percent annual rate, enough to erase more than $2 trillion in household wealth. Simultaneously, the expected drop in house prices over the coming year accelerated further to 12 percent. That outcome would push the cumulative drop in house prices above 20 percent, enough to erase more than $5 trillion in household wealth. After the release of these numbers, the value of securities tied to the assumption that house prices only rise began to erode further, and the cost of buying protection against defaults rose more sharply. For an investment bank like Bear Stearns, heavily exposed to mortgage instruments, the crisis that arose in mid-March was in no way "out of the blue" but was tied closely to the deteriorating underlying conditions in the housing sector and the real economy.

Broadly speaking, the Fed's measures—such as those enacted in March—to provide additional liquidity, culminating in the commitment to supply unlimited funds to banks and investment banks, are largely defensive. They are aimed at avoiding a further deterioration in credit conditions that would further weaken the real economy and, in turn, tighten credit conditions even more. To contain an incipient credit collapse, the Fed has needed to use virtually all of the traditional tools available to it and to contemplate printing more money, an option not employed since the Great Depression. With all of these steps undertaken, the hope is to break the self-reinforcing cycle between a weakening credit sector and a weakening economy.

Nationalizing the Mortgage Market?

Addressing the fundamental problem—the persistent and accelerating fall in house prices—will require legislative action that will, to some extent, nationalize the mortgage market. This approach is understandably abhorrent to many and carries with it substantial risks of involving the federal government in mortgage markets to a greater extent than is already the case. If steps to contain the damage being caused by a free fall in house prices result in a return to the idea that house prices go only up and that they are underwritten by the federal government, we will see another housing and credit bubble even larger than the one that has already been threatening the global economic system.

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We are probably at a point, however, where we need to choose between two approaches to putting a floor on house prices. Either have the Fed print so much money that a return to inflation eventually stabilizes house prices and then pushes them back up—the radical monetize approach—or, alternatively, employ the nationalize approach, whereby a federally funded agency steps in to buy mortgages at less than their current face value to help stabilize the credit markets. The Fed's commitment to ensure price stability makes the nationalize approach the only realistic option, however unattractive it may be.

The current plan, jointly sponsored by Representative Barney Frank (D-Mass.) and Senator Chris Dodd (D-Conn.), would create a voluntary program whereby mortgages at risk of default could be sold to a government agency for, say, seventy-five cents on the dollar. The actual number will be determined by an appraised (lower) value of distressed property. The household borrower would then be allowed to renegotiate payments on the smaller mortgage. The lender would sell the distressed (less valuable) mortgage to the government agency for a figure around 85 percent of its lower appraised value, on the notion that that outcome would be better than an outright default, which could leave the lender with only fifty-five or sixty cents on the dollar. That would leave the government agency taking the risk attached to a possible default, even on the smaller mortgage.

In effect, this approach would place the burden on lenders and taxpayers. Lenders would take a definite write-down of around 25 percent in exchange for the ability to realize 75 percent on the mortgages. Given that the government agency would then assume the mortgages, taxpayers would assume the risk of any defaults or further write-downs. The debt of households struggling to pay mortgages would be reduced by the equivalent of 25 percent of outstanding mortgages, up to a ceiling of $300 billion under the Frank-Dodd plan.

The Frank-Dodd program is currently envisioned as requiring the assumption of about $300 billion in mortgages with a low cost to taxpayers, since 5 percentage points of the 15 percent write-down on the reduced mortgage would be paid by the lender to the Federal Housing Administration. The cost could rise, however, if broader measures are undertaken, and the ultimate cost to lenders and taxpayers will very likely rise rapidly to $500 billion or more. It is very difficult to draw a line between mortgage holders who deserve relief from the federal government and those who do not, especially as the pain tied to credit restrictions and falling home values spreads to more and more households. Currently, those who do not need mortgage relief are being far more active in communicating with Congress than those who do. Reports from Capitol Hill early in March estimated that mail was running 9–1 against mortgage bailouts. The mail in favor of bailouts will increase as the pain of falling house prices affects more and more households. That pain may take the form of a further weakening of the economy and attendant job losses, as well as cancellation of existing credit lines by beleaguered banks.

The timing on the move to partial nationalization of the mortgage market and the scope of that nationalization depend critically on the pace at which legislation can be written and enacted. The inevitably slow pace of this process partly accounts for the immense pressure on the Federal Reserve to try to contain the problems in credit markets that are tied to rising uncertainty about the ultimate drop in real estate prices.

The outlook for quick action is uncertain. What will likely become a Frank-Dodd bill presumably will not be introduced in Congress until the beginning of April at the earliest, when Congress returns from its annual Easter/spring recess. Democrats are reluctant to move too aggressively for fear of the negative backlash against bailouts of households that bought more house than they could afford, while Republicans are ideologically opposed to the nationalization of the mortgage market. Both have a point, but the fact remains that until some action is taken to legislate a means to stabilize house prices, they will continue to fall, and the pressure in credit markets will continue to rise. This prospect forces the Fed closer and closer to the monetization option. By May, Congress will probably be fearful enough of the negative fallout from mortgage delinquencies and foreclosures to pass a version of the Frank-Dodd bill.

Until some action is taken to legislate a means to stabilize house prices, they will continue to fall, and the pressure in credit markets will continue to rise.

The economic stabilization package enacted earlier, which will send $100 billion to households between May and July, ironically may delay legislative action on support for the housing market because many in the administration insist that the package will be sufficient to solve the problems in the economy. That will likely prove a vain hope, since the $100 billion will just compensate American households for the increase in energy prices over the last six months. But if Congress passes a Frank-Dodd bill by a veto-proof margin in May—as seems increasingly likely—the president will be unable to prevent it from becoming law.

Suffice it to say that the next president will probably want to expand the Frank-Dodd bill template to include a much larger homeowner bailout. The bill is currently designed to expedite that process. The question is whether it would provide sufficient relief in the meantime. We may see a lame duck Congress called into session at the end of 2008 to speed passage of a more ambitious mortgage bailout.

Conclusion

The cycle of denial, hope, and panic that has caused stock prices, interest rates, commodity prices, and exchange rates to oscillate more and more widely since the onset of the credit crisis in August 2007 and that was followed by the wide recognition of a U.S. recession in

March 2008 will continue. The Fed's dramatic moves on March 16 to prevent an outright failure of Bear Stearns and to offer unprecedented open credit lines to investment banks triggered a frantic rally in shares of investment banks. The price of Goldman Sachs shares rose from a low of $140 on March 17 to $175 on March 18. This 18 percent increase was aided by the Fed's 75-basis-point rate cut on March 18. Simultaneously, shares of Lehman Brothers more than doubled from $20 to $45 a share, while shares of Bear Stearns more than tripled from $2 to $6 a share, having been as high as $65 per share on March 14, just after the Fed announced it would take what was then the unprecedented step of lending to Bear Stearns. After Bear's stock subsequently collapsed, despite the Fed's March 14 effort, the more radical step of offering to lend directly to all investment banks was taken on March 16 in an effort to stem a panic in Asian markets.

The pattern of market panic and reaction by the Fed to save the day, at least for a short time, has been repeated over and over again and with rapidly increasing frequency since last August. By the end of the day on March 19, stocks had already reversed their sharp rally of the day before. Then they turned up again on March 20, but without establishing any new trend. The frequency of Fed reactive moves to stem panic has reached an alarming pace since March 7, the day a weaker-than-expected employment report signaled recession to all. Special measures were undertaken on March 7, 11, 14, and 16, followed by the 75-basis-point cut of the fed funds rate after the Open Market Committee's regular March 18 meeting. If the pattern in place since August persists, a sharp stock market rally and reduced stresses on credit markets will signal hope that the worst is behind us, until a worse-than-expected economic number or rumored trouble at another financial institution brings back panic and moves us another step toward monetization by the Fed.

There is really no way to tell which particular Fed move or legislative action will end—or at least contain—the adverse feedback loop from weaker credit to weak economy and back to weaker credit. Until there is some realistic hope that house prices will stop falling while the extent of credit losses is known, it is difficult to see an end to the rising volatility in markets tied to ever-widening cycles of denial, hope, and panic.

Notes

1. For an excellent account of the role J. P. Morgan played in dealing with and profiting from numerous financial panics, see Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Grove Press, 1990).