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# Tipping Point

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The annual report of the Bank of International Settlements (BIS)—the central bankers' central bank—which appeared in late June, was somewhat schizophrenic. On the one hand, the BIS called for world interest rates to rise in order to deal with a "clear and present threat" from global inflation while, on the other hand, it warned that the global economy may be close to a "tipping point" into a "slowdown severe enough to transform the current period of rising inflation into a period of falling prices." The simultaneous rise in oil prices and the fall in yields in government securities occurring as the BIS released this ambivalent statement captured well the tensions inherent in the stagflationary crosscurrents facing the global economy. Against this ominous background, the release of the BIS report coincided with the onset of a global bear market in equities.

The sharp drop in oil prices that occurred in mid-July may be a hint that the global economy is slowing rapidly enough to cap the rise in energy costs. But plenty of damage has already been done. Even if the price of oil had fallen enough to average about $125 a barrel during July, the annualized saving for U.S. consumers would have been about $37 billion—not a tiny amount, but hardly enough to revive the U.S. economy on its own.

It is easy to forgive the BIS and other analysts some ambivalence concerning the outlook for the U.S. and global economy. Since the collapse of the Bear Stearns hedge funds in June 2007 and the emergence of a full-blown "subprime" crisis in August 2007, a three-part whirlwind has enveloped global financial markets and the world economy. The first part is the persistent and accelerating drop in home prices in the United States, the United Kingdom, and parts of Europe. Second is the steady stream of ad hoc policy efforts to deal with what are described as "liquidity problems" in the U.S. financial system. These efforts continued in July with the extraordinary and heretofore unimaginable step of having the Federal Reserve open its discount window to mortgage giants Fannie Mae and Freddie Mac while the Treasury tries to cobble together a package to enable these institutions to continue making mortgage loans to help households purchase a rapidly depreciating asset. Third is the continuing crisis at banks and investment banks tied to the steady rot of housing assets that underlies large portions of their balance sheets.

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This messy collection of negative crosscurrents is taking its toll on financial markets and on household confidence to such an extent that the dreaded "adverse feedback loop"—whereby deteriorating financial sector conditions result in slower economic growth, which in turn intensifies negative conditions in the financial markets—has reemerged. With the emergence of a more intense down phase in real estate in the United Kingdom and economic slowdowns emerging in Europe and Japan, the adverse feedback loop has gone global.

### Falling Home Prices Still the Problem

The fundamental reason that the earnings reports of U.S. banks and investment banks continue to contain "negative surprises" is the steady and accelerating decline in U.S. home prices. The second-quarter earnings reports of U.S. banks have embedded in them a wide variety of assumptions

regarding the actual and prospective path of U.S. home prices, which in turn determine the value of mortgage assets on the banks' balance sheets. Currently, expected peak-to-trough declines in real estate prices based on the Case-Shiller Ten-City Index are about 33 percent. According to Oppenheimer equity research bank analyst Meredith Whitney, while Bank of America is currently assuming a 30 percent peak-to-trough decline, Citigroup, Fannie Mae, and Freddie Mac are assuming declines of about 20 percent, while JPMorgan Chase is assuming total declines of 23–25 percent. Wachovia Bank is assuming a decline of 12.9 percent based on the Office of Federal Housing Enterprise Oversight Housing Price Index, which reports prices tied to higher-quality conforming mortgages.

The deteriorating condition of commercial- and investment-bank balance sheets tied to the continued drop in house prices has taken its toll. Since early May, prices of the stocks in the Standard & Poor's financial index have dropped by about 25 percent—even after a sharp 15 percent rebound in mid-July.

Among the share prices of U.S. financial institutions, those of Fannie Mae and Freddie Mac, the mortgage giants with $5 trillion in mortgage assets, have suffered the most. The shares of Fannie Mae and Freddie Mac move largely in tandem. Since last fall, shares of Fannie Mae have fallen from a high of about $70 to about $15 a share in mid-July. The rapid deterioration of share prices is tied to two factors. Fannie Mae and Freddie Mac, along with the Federal Housing Administration, have continued to make mortgage loans effectively equal to nearly the full value of the property being purchased. This activity has provided virtually the only source of lending for U.S. homebuyers. But because it means that Fannie Mae and Freddie Mac continue to acquire mortgages for which the underlying asset—housing—is deteriorating, the quality of their balance sheets is deteriorating, too.

The sharp drop in the value of the common stock of Fannie Mae and Freddie Mac is related to the likely dilution of common shareholders who are the junior claimants on the resources of those institutions. As the mortgage market crisis has continued and the reliance on those institutions as the only suppliers of mortgage finance has grown, the need for them to raise more capital in order to continue their lending activities has increased the likelihood that Fannie Mae and Freddie Mac will need to issue senior debt or preferred shares. The effect of issuing more senior debt is to dilute the claim that common shareholders have on the assets of the institutions. As recently as May, the shares of Fannie Mae, for example, were trading at about $30 a share. As markets began to realize that more funding would be required, the shares fell to about $20 per share by the end of June. During the first half of July, as markets began to realize that there was very little interest among private investors to purchase any additional claims on Fannie Mae or Freddie Mac, it became clear that the U.S. government would have to arrange additional financing for both of these government-sponsored enterprises (GSEs). That realization pushed the share price of Fannie Mae from $20 a share at the end of June to below $10 a share, before the shares recovered to $15 a share on hopes of a government bailout.

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The details regarding a proposal for continued funding of Fannie Mae and Freddie Mac through a Treasury-sponsored financing effort, outlined to Congress by Treasury secretary Henry Paulson on July 15, remain murky. Paulson's stated aim appears to be to reassure markets that the U.S. Treasury will stand behind additional borrowing by Fannie and Freddie aimed at enabling them to continue to finance mortgage loan growth. But given the massive scale of Fannie Mae and Freddie Mac operations—their combined guarantee of mortgage-backed securities amounts to $5 trillion, almost half of the $12 trillion national mortgage market—the cost of such a guarantee remains a serious issue. The Congressional Budget Office (CBO) has estimated a cost of $25 billion with a range of zero (if the facility is not used) to $100 billion if mortgage conditions worsen.

Paulson encountered substantial resistance from some Republicans in Congress who wanted to know what kind of securities Fannie and Freddie would be issuing and how much underwriting those securities would cost the U.S. government. In order to pass legislation, Congress may need to see a cap on the cost of the Fannie and Freddie rescue operation that is a relatively low number—perhaps on the order of $5 billion or $10 billion. In view

of the size of the mortgage exposure of Fannie and Freddie, a believable rescue package could cost substantially more—closer to the $100 billion high end of the CBO estimate. Despite the potential cost, Congress appears poised to pass legislation that increases Treasury credit lines to Fannie and Freddie and offers credit guarantees—apparently unlimited ones—to underwrite further borrowing.

## Policymakers Still Far Behind

The Bush administration Treasury proposals to inject additional funds into Fannie Mae and Freddie Mac are typical of an ongoing series of ad hoc policy efforts that have been forthcoming as the mortgage crisis has unfolded. Neither the Federal Reserve nor the Treasury has distinguished itself in this process, either for having been forward-looking or for having been realistic about the scope of the problem before them. As recently as July 2, in a London speech at Chatham House, Paulson emphasized the need for market discipline to reinforce market stability:

> For market discipline to be effective it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available. . . . For market discipline to constrain risk effectively, financial institutions must be allowed to fail.[1]

Just ten days later, Paulson was immersed in an over-the-weekend effort to cobble together a plan to provide government support for Fannie Mae and Freddie Mac. The point is not that Paulson had any choice but to move to rescue Fannie and Freddie once their stock had collapsed and a crisis had emerged. The same situation faced the Federal Reserve in the March 2008 Bear Stearns crisis. The point, rather, is that denial over a severe underlying problem in housing finance results only in repeated crises wherein financial market turmoil—itself damaging to confidence—forces ad hoc emergency measures that do not address the root of the problem.

As if the problems facing Fannie Mae and Freddie Mac were not enough as the acute phase of their crisis emerged, IndyMac Bank, a major California mortgage lender (a Countrywide spin-off) failed, leaving panicky depositors lined up outside the bank's offices. The rescue of guaranteed deposits consumed about $5–6 billion of the $53.5 billion in reserves held by the Federal Deposit Insurance Corporation, the major federal deposit insurer.

> The key to stabilizing the housing market is to slow, or at least to truncate, the drop in house prices so that homebuyers do not face prohibitive real costs to purchase a home.

The Securities and Exchange Commission responded to the crisis by trying to prevent sales of financial shares by constraining short selling. Meanwhile, Congress worked on legislation to deter the purchase of oil contracts by "speculators." There were no such constraints suggested when financial shares were surging on the back of a housing bubble or when oil prices were collapsing during the last recession. Proposing laws or implementing rules to prohibit or limit selling of financial shares or buying of energy are signs of desperation aimed at symptoms, not causes.

The Fed has been curiously eager to embrace a benign scenario for the U.S. economy and the U.S. financial sector. Early in June, Fed chairman Ben Bernanke suggested in two major speeches that the downside risks to financial markets and the economy had been substantially reduced. A little over a month later, during his semiannual Humphrey-Hawkins testimony to Congress, Bernanke reversed course:

> The possibility of higher energy prices, tighter credit conditions, and a still-deeper contraction in housing markets all represent significant downside risks to the outlook for growth.[2]

Bernanke also had to acknowledge that possibly rising inflation pressures continue to be of concern to the Fed. As if to underscore that concern, the July 15 report on U.S. consumer prices showed an unnerving acceleration in the Consumer Price Index increase to 5 percent year-over-year from 4.2 percent in the previous month. Year-over-year core inflation also accelerated from 2.3 percent in May to 2.4 percent in June. The BIS annual report's schizoid tone is haunting Bernanke, who clearly is dealing with a very difficult set of problems in financial markets and the economy.

The underlying situation facing the Fed and the Bush administration, given the bursting of what has turned out to have been a massive housing bubble, is highly challenging. There are no easy solutions. That said, the persistent oscillation among leading policymakers between frantic efforts to shore up the financial system in a crisis environment—such as appeared with the Bear

Stearns crisis in March and the Fannie and Freddie crisis in July—and assertions that the situation is stabilizing and that no intervention will be needed have been counterproductive. The time may have come, especially against a backdrop of what looks to be a weakening global economy in the second half of 2008, for policymakers to take the first step toward acknowledging underlying problems and moving on to designing some large-scale solutions. These might include an expansion of the Federal Reserve's balance sheet along with steps to nationalize Fannie Mae and Freddie Mac, since taxpayers' funds look to be a necessary feature of their viability going forward. Tax cuts should not be excluded from the possible stimulus menu for the U.S. economy.

> Of the two concerns expressed by the Bank of International Settlements—more inflation pressure versus a tipping point into a potential deflationary environment—the latter is probably the greater risk.

## Second-Half Growth Will Slow

The urgency of acknowledging the scope of problems in the housing market and the associated problems in the mortgage securities market is growing. Growth in the U.S. and global economies looks set to slow during the second half of 2008, adding to the risk of an adverse feedback loop from the real economy to a further intensification of underlying problems in the credit market.

In the United States, growth during the first quarter was 1 percent, with modest contributions from consumption and net exports in government spending partially offset by a sharp 1.1 percentage point drag from continued falling residential investment. Second-quarter growth appears to have been about 2 percent, thanks to a strong contribution from a surge in consumption tied to distribution during the quarter of $110 billion in tax rebates. The contribution from net exports will probably continue, as will the drag from falling residential investment.

Looking into the second half of 2008, the boost to consumption from rebate checks will atrophy rapidly, with the last of the checks having been distributed by mid-July. The retail sales report for June suggested that the primary stimulus from rebates probably came during the three months ending in May. Overall, June retail sales rose by a mere 0.1 percent in nominal terms, down notably from 0.8 percent during May. Taking out the 4.6 percent increase in spending at gasoline stations tied largely to higher oil prices, retail sales actually fell in nominal terms at a 0.5 percent annual rate during June. With the peak impact of the stimulus package probably having been reflected in stronger-than-expected May retail sales, the trajectory from the second to the third quarter for consumption spending looks to be sharply negative.

The U.S. employment report for June, which appeared on July 3, established a firmly negative trajectory for U.S. growth. It contained substantial downward revisions to previous months' employment growth that took the year-over-year increase of employment to zero—a sure sign of recession. Beyond that, the jump in the unemployment rate to 5.5 percent, which had been viewed as a fluke in the previous month's report, was sustained. A reliable leading indicator of the overall labor market—temporary services employment—accelerated downward, suggesting a further, future rise in aggregate job losses and an accompanying rise in the unemployment rate to more than 6 percent.

## Even Lower Home Prices

Countering the gloom in the housing sector, some analysts have suggested that the drop in home prices has improved affordability in the sector so that buyers may soon be willing to step in. While the price of homes has dropped sharply, the effect has been to deter homebuyers. That is because the real cost of homeownership for prospective buyers who are borrowing to purchase a home has increased markedly. During the real estate run-up, promoters of home sales liked to point out that even if mortgage costs were 6 percent, a steady 10 percent annual rise in house prices meant that the "real" cost of homeownership was –4 percent, with the housing appreciation more than paying for the mortgage. In today's market, with borrowing costs still 6 percent or a little bit higher, as house prices drop at a 10 percent annual rate, by the same method of calculating the real cost of homeownership, the outcome is 16 percent. This daunting reality facing prospective homebuyers has led many to hold off on home purchases and to wait for lower prices, thereby pushing home prices down even further.

The key to stabilizing the housing market is to slow, or at least to truncate, the drop in house prices so that

homebuyers do not face prohibitive real costs to purchase a home. The underlying problem is that while the futures markets see a slowdown from the 2008 current 17.8 percent drop in house prices to 9.1 in 2009, the real cost of home-buying will remain prohibitive through the end of next year. That prospect is at the root of the sharp deterioration in the balance sheets of GSEs as they continue to provide nearly 100 percent financing for homebuyers who are apparently more optimistic about the prospect for home prices than futures markets. Unfortunately, the rapid drop in home prices is not likely to taper off until late 2009.

Adding to the prospect for an adverse feedback loop running from the real economy to financial markets is the prospect of an intensifying slowdown in the global economy during the second half of 2008. The U.K. economy has already begun to experience an increasingly intense reduction in home values and a rise in the prospects for recession. European economic indicators have swooned, too, including a sharp 2.4 percent fall in May in German industrial production that points to negative GDP growth in the second quarter and indicates broad weakness in Europe. Similarly, in Japan, most indicators of economic activity are slowing rapidly enough to indicate a negative growth rate for the second quarter. A slowdown in global growth reduces the potential contribution from net exports to U.S. growth, which, in turn, could place further downward pressure on employment.

The sharply elevated degree of market volatility in mid-July was accompanied by a sudden drop in oil prices from about $145 a barrel to below $130 a barrel in the space of a few days. This was good news insofar as it reduced the drag on consumers from higher energy costs, although, as already noted, the contribution to real disposable income in the case of the United States is modest. A drop in energy prices seems reasonable in the face of a slowing global economy that would see a reduction in the growth of demand for energy. The drop in oil prices may, in fact, be a symptom of the very global slowdown that some optimistic market participants are hoping will not occur.

## Tipping Down?

Of the two concerns expressed by the BIS—more inflation pressure versus a tipping point into a potential deflationary environment—the latter is probably the greater risk. If oil prices begin to move lower while the global economy slows, central banks may feel more comfortable undertaking a proactive expansion of liquidity aimed at stabilizing house prices. Unfortunately, the threat of inflation, just underscored by the June data for the Consumer Price Index, will keep central banks on hold or, in the case of the European Central Bank, leaning toward further tightening until well into the fall. Meanwhile, look for a continued, rapid drop in home prices, the emergence of more troubled financial intermediaries, and continued "rescue packages" such as those that have characterized the last year. My call earlier this year for "fine in 2009"[3] is looking premature. For now, we can only hope for better times again in 2010.

## Notes

1. Henry Paulson (speech, Chatham House, London, July 2, 2008), available at www.ustreas.gov/press/releases/hp1064.htm (accessed July 24, 2008).

2. Ben S. Bernanke, "Semiannual Monetary Policy Report to the Congress" (testimony, Senate Committee on Banking, Housing, and Urban Affairs, Washington, DC, July 15, 2008), available at www.federalreserve.gov/newsevents/testimony/bernanke20080715a.htm (accessed July 24, 2008).

3. John H. Makin, "Fine in 2009 (Not So Great in 2008)," *Economic Outlook* (January 2008), available at www.aei.org/publication27309/.