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Panic

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When you see your neighbor carryin' somethin',
Help him with his load,
And don't go mistaking Paradise
For that home across the road.

—Bob Dylan, "The Ballad of Frankie Lee and Judas Priest," 1968

The credit crisis that followed the collapse of the housing bubble turned into a financial panic on Wednesday, September 17, 2008. There was a run by households out of money-market funds and into safe Treasury bills, pushing their yields to zero for the first time since the Great Depression. There was a liquidity trap in the interbank market, in which banks that are supposed to lend to each other hoarded cash for fear of runs by their depositors and the insolvency of other banks. Financial markets simply froze in the midst of chaos.

Reactive to Proactive

The time had come—indeed the time had long since passed—for the Federal Reserve and the U.S. Treasury, together with other G7 central banks and treasuries, to move from a reactive, piecemeal approach in the face of a global financial crisis to a proactive, systemic approach. The Fed injected $105 billion into the banking system (having already injected $140 billion earlier in the week) to deal with a full panic run on money-market funds. Treasury secretary Henry Paulson and Fed chairman Ben Bernanke went to Congress, ashen-faced, to promise a proposal to provide further systemic support for the mortgage market. Other G7 central banks and treasuries did nothing. They view this as an American problem.

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The proximate problem is simple, but the legislative solution being proposed by Paulson—a big bailout for holders of mortgage securities—is going to be messy and expensive. The underlying problem remains the continued drop in house prices, which has severely curtailed the liquidity and value of trillions of dollars of mortgage-backed securities (MBS) held by financial institutions around the world. Burgeoning credit problems tied to the bursting of a housing bubble have threatened the economy, whose weakness has, in turn, further weakened the housing market and further exacerbated credit problems. The long-dreaded adverse feedback loop is now a reality. Apparently, having named the disease, the Fed and the Treasury have not—until now—realized that it needed to be treated, and treated aggressively.

We have reached a point in this highly disconcerting cycle at which a collapse of the housing market has totally frozen financial markets to a point at which banks are unwilling to lend to each other because they must conserve cash for fear of substantial withdrawals by panicky depositors. To

repeat, the collapse in the housing market could lead to a further weakening of the economy and a further collapse of housing. This dynamically unstable downward spiral must be interrupted.

The leadership for this daunting task would better have come from the Federal Reserve, which, faced with an immense and growing financial crisis, has held to a reactive, piecemeal approach concerning the rapidly deteriorating U.S. economy, but even more so concerning the global financial crisis that has been growing at a terrifying, exponential pace in September.

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Consider the September 16 statement by the Fed's major policymaking arm, the Federal Open Market Committee (FOMC). While the Fed acknowledged that "strains in financial markets have increased significantly and labor markets have weakened further," it opined hopefully that "over time, the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity should help to promote moderate economic growth." The concluding paragraph in the statement suggested that "the downside risks to growth and the upside risks to inflation are both of significant concern to the Committee." While this seems like a prudent statement, it is virtually unchanged from the text of the FOMC's August 5 statement, despite a frightening acceleration in the downward momentum of financial markets and the real economy since early August.

Panic Prelude

In September alone, financial markets have been hit by wave after wave of crisis while the economy has shown signs of abrupt slowing highlighted by the jump in the August unemployment rate from 5.7 percent to 6.1 percent. On September 7, the U.S. government placed the two large heretofore quasi-governmental mortgage organizations, Fannie Mae and Freddie Mac, into conservatorship—a state usually considered a way station on the road to bankruptcy—and removed their top management. In effect, the former step wiped out the value of Fannie and Freddie's common and preferred shares. In an effort to reassure markets, the Treasury pledged to put up to $200 billion in support of the two institutions. Unfortunately, while electing to deal with the moral hazard problem tied to bailouts, by wiping out common and preferred shareholders of Fannie and Freddie, the Treasury's action unnerved equity markets further. The idea that a bailout came to carry with it a total loss of value for common and preferred shareholders meant increasing downward pressure on the shares of other troubled institutions.

With investment banks under heavy pressure in view of large losses in MBS, their shares were the next to suffer. On September 14, after a virtual collapse of its stock price, Lehman Brothers filed for bankruptcy. On September 15, Bank of America absorbed Merrill Lynch for $50 billion in a purchase deemed necessary to rescue the brokerage giant from outright bankruptcy. At 9:15 p.m. on September 16, the day it released the complacent FOMC statement, the Fed agreed to lend the collapsing insurance giant AIG $85 billion at 12 percent in exchange for an 80 percent stake in the company, whose nominal value was $1 trillion. Its real value was substantially less, but indeterminate. AIG's common stock had become all but worthless—the fate of a bailout candidate. Its outright failure threatened to precipitate a run on money-market mutual funds, the repositories of trillions of household cash balances. To underscore the fear surrounding the solvency of money-market funds, on September 17, the Reserve Primary Fund "broke the buck," meaning that the face value of its near-cash equivalent deposits fell below $1. Withdrawals from the fund were suspended so that, for example, if a household had intended to use assets in the Reserve Primary Fund either to pay taxes or its mortgage, the funds were not immediately available.

The result of these almost surreal events occurring in such rapid succession was, as noted above, a panic run into Treasury securities by households and businesses, thus pushing yields on Treasury bills virtually to zero on September 17 and 18. Households and businesses sought the safety of direct claims on the government in favor of deposits at money-market funds or even in checking accounts. Thoughts about yield were abandoned in favor of wealth preservation, and, on September 17, the interest on four-week Treasury bills actually dropped to –1 basis point, meaning that investors were willing to pay the Treasury to store cash for the first time since the Great Depression. That sure sign of panic over the safety of the U.S. banking system came less than twenty-four hours after the FOMC attempted to reassure markets about "ongoing measures to foster market liquidity." With its statement, the Fed was trying to walk the difficult line between supporting the economy and the

financial system and showing vigilance against inflation. The events in the financial system, however, coupled with the market's assessment of the outlook for inflation suggested that, at a very bad time, inflation was not a primary concern of markets.

While markets had, until mid-July, been signaling higher expected inflation as commodity prices were driven to new heights, that fear has since sharply abated. Oil prices peaked at $147 a barrel in mid-July but since have plunged by about a third to below $100 a barrel. Simultaneously, other commodity prices have dropped as news of a rapidly slowing global economy has reversed the upward pressure on commodity prices while weakening the outlook for global growth. It is hard to square the Fed's persistent concerns about inflation with the drop-off in commodity prices as the U.S. and global economies have slowed. The yield on ten-year government securities dropped from 4.1 percent to 3.4 percent on September 16, the day of the FOMC meeting. During the same period, the yield on five-year government securities dropped from 3.5 percent to 2.5 percent. The measure of expected inflation derived from a comparison of yields between Treasury Inflation-Protected Securities and Treasury notes not carrying inflation protection suggested that inflation expectations over a five-year horizon had dropped from 2.5 percent in July to 1 percent on September 17. The Fed's continued preoccupation with inflation fears now appears near delusional in the midst of financial panic.

The events in the financial markets have taken their toll on risky assets, including stocks. The S&P 500 Index began the year at about 1,500; sold off to a level below 1,300 in mid-March, at the time of the Bear Stearns crisis; and then rose back above 1,400 during May, as hope returned that the U.S. economy would recover thanks to the stimulus package and the supposed end of the financial crisis. Thereafter, stocks have continued to drop, especially during September. By September, the S&P 500 had fallen to about 1,150, losing nearly a quarter of its value since the beginning of the year. Other stock markets fared no better, with European stock markets falling by about a third since the start of the year and shares in emerging markets falling even more sharply in some cases. By mid-September, the Chinese stock market had dropped more than 60 percent from the start of the year, while the troubled Korean stock market, once a favorite, fell by 26 percent in terms of the Korean currency and by 40 percent when adjusted for the decline of the Korean currency against the dollar.

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The damage to financial markets worldwide has taken its toll on the global economy. Growth in Japan and Europe turned negative at midyear, while the Chinese economy appears to be slowing rapidly. In the second quarter, the U.S. economy grew, thanks to a huge boost from exports and $150 billion of tax rebate checks. In the third quarter, it looks as if U.S. growth will drop sharply—probably to –1.5 percent at an annual rate. As mentioned earlier, the U.S. unemployment rate jumped to 6.1 percent in August. Simultaneously, consumption spending has dropped sharply and will probably contract for the first time since 1991. The near panic in financial markets that has filled newspapers in September will lead to sharp drops in consumption, investment, and employment as households and businesses try to conserve or actually raise cash. (September 15 was a due date for corporate and household quarterly tax payments. Preliminary data suggest a sharp drop in payments, caused either by lower profits, lower incomes, or a simple inability to pay.)

Messy Legislative Response

There are no easy or painless solutions in this extraordinarily difficult environment that rivals the financial and economic challenges of the Great Depression. A number of concrete, proactive, and systemic steps might have averted the September 18 panic that resulted in the steps to thwart a run on money-market funds and the messy legislative approach to a bailout of the financial system. The panic of September 18 and the forced move to an expensive and risky legislative approach to stabilize the mortgage market could have been avoided if the Fed had moved to expand its balance sheet by printing money, as I advocated in the *Wall Street Journal* on April 14, 2008.[1]

The Fed should be offering a clear promise to nervous depositors of banks and money-market funds. (The Fed did, on September 19, provide a $230 billion backstop for money-market funds, but on September 21, eligibility for that guarantee was limited to include only balances as of September 19.) Depositors should instead get a clear, broad commitment: "If you want to

convert your bank deposit into cash, you are free to do so." Once a number of nervous depositors discover that they could withdraw as much as they want from either a bank or a money-market fund, the run on depository institutions would cease. After a time with cash in hand, depositors would realize that as the system stabilizes and as the possibility of a modest, temporary reflation rises, it would be wise to redeposit their funds in banks and money-market funds in order to receive a market rate of interest. Eventually, the stabilization of the financial system would help in turn to stabilize the mortgage and housing markets, and—with luck—a serious deflationary crisis accompanied by an economic collapse would have been averted.

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To reduce the risk of panic among depositors, the Treasury should buttress the Federal Deposit Insurance Corporation to insure all depository accounts. The insurance ceiling, now at $100,000, is grossly inadequate, especially for the small businesses that must maintain such depository accounts for the normal conduct of business, including the meeting of payrolls. The risks attached to expanding depository insurance to cover all deposits are far outweighed by the risks of having a number of the nation's small businesses unable to meet payroll because of losses on uninsured deposits over $100,000.

The Treasury's proposal to Congress to allow the purchase of MBS directly from banks, investment banks, and insurance companies will be difficult to effect. Currently, such "private label" mortgage securities are challenging, if not impossible, to value. Their holders refuse to sell them at offer prices that would clear the market because such prices would raise questions about the solvency of many financial institutions that own the more than $10 trillion of U.S. mortgages outstanding. Electing to hold on to mortgage securities in the hope of receiving a better price in the future requires financing the holdings. With house prices continuing to fall, the cost of financing has risen sharply and, in some cases, has become unavailable at any price. The result has been acute distress and, in some instances, outright failure (as in the case of Lehman Brothers) or the need for a firm to sell itself to a large bank (as in the case of Merrill Lynch's absorption by Bank of America). As the plight of these institutions threatened Morgan Stanley and Goldman Sachs, systemic panic set in, and Paulson and Bernanke had to go hats in hand up to Capitol Hill for some real money—upwards of $700 billion.

Moving ahead, if the Treasury offers too much for the distressed MBS owned by banks and others, the cost of the bailout will skyrocket. It could become counterproductive if the prospect of another $700 billion–plus in Treasury borrowing pushes interest rates higher or forces the Fed to print money. If offer prices are too low—far below current make-believe values being placed on MBS by their owners—solvency risks will rise.

In short, this new program is not a Resolution Trust Corporation program. That program in the early 1990s involved the government taking over failed savings and loan institutions and auctioning off their assets. Now, the Treasury will be approaching existing institutions whose valuation of the MBS they hold is generous, to say the least. This knotty issue—among many others—may slow the passage of MBS bailout legislation. No doubt it will substantially raise the cost as Congress trades a "Wall Street bailout" for Main Street pork with, perhaps, a bailout for General Motors and Ford thrown in for good measure.

Opportunities Lost

As I said last April:

> The policy alternatives in the post-housing-bubble world are painfully unpleasant. In my view, the least bad option is for the Federal Reserve to print money to help stabilize housing prices and financial markets. Yes, use reflation to soften the pain for Main Street and Wall Street. If instead we let housing prices fall another 25–30 percent—as predicted by the Case-Shiller Home Price Index—it's almost certain that Washington will end up nationalizing the mortgage business.[2]

Now we are seeing Washington move toward nationalizing the mortgage business at a cost (initially) of

close to $1 trillion once the extra cost of the MBS bailout program is added to the cost of GSE bailouts and associated pork extracted by Congress in exchange for MBS legislation. Further, the resource misallocation that will result from the tidal wave of legislation from Congress in response to the mortgage mess could cost another trillion dollars. Sadly, the new wave of regulation will just replace extant regulation. Had existing regulations been implemented, they would have precluded, or at least mitigated, the housing bubble whose bursting precipitated a financial crisis that turned into a financial panic.

There is a simple solution to the fundamental housing-bubble problem that lies behind the panic. An institution that makes a mortgage loan should be required to keep that loan on its balance sheet. That will mean higher interest rates on mortgages, but that is unavoidable. If policymakers understand why that is so, the problem need not be repeated. If they do not, we will have another housing bubble.

Notes

1. "[T]he Fed's intervention [to rescue Bear Stearns] has done no more than buy a respite from the crisis in the financial markets. The monetary easing I'm recommending can occur by having the Fed print money to purchase mortgages directly, or purchase Treasury securities directly. The latter is probably more desirable because it adds higher-quality assets to the Fed's balance sheet. The Bank of Japan was also forced to reflate by printing money in 2001, after two years of a zero interest-rate policy failed to lift the economy out of a prolonged recession that had moved Japan to the brink of a deflationary crisis. . . . The Fed should announce its intention to add to its holding of Treasury securities in order to provide additional liquidity. It should cease pegging the fed funds rate while this policy is in effect. While there is no guarantee, direct injection of money holds some promise of alleviating the worst of the credit crisis." (John H. Makin, "The Inflation Solution to the Housing Mess," *Wall Street Journal*, April 14, 2008, available at www.aei.org/publication27807/.)

2. Ibid.

For a comprehensive survey of AEI scholars' research on the financial crisis over the past several months, see www.aei.org/FinancialCrisis/.