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The Crisis and Fix Cycle

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The global financial and economic crisis that emerged in August 2007 has entered a dismaying fourth phase. The January 17–18, 2009, weekend edition of the *Financial Times*, which has been a major chronicler of the crisis and its many aspects, laid out a frightening timeline of an accelerating and intensifying oscillatory cycle of crisis and failed policy response that started just fifteen months ago.[1] Each phase begins with a shock and ends with a seemingly decisive policy measure meant to contain or "fix" the crisis. Each phase is shorter than the previous one and culminates in a much larger policy response. Throughout the crisis, the losses of financial institutions have steadily grown at an accelerating pace as the underlying conditions in the financial sector and, since September 2008, in the underlying global economy deteriorate more rapidly. Such a disturbing pattern must be truncated by a large, coordinated global policy response to arrest the accelerating erosion of the market capitalization of multinational banks and insurance companies that has resulted.

Based on the figures in the *Financial Times* article, as each larger policy response has failed to arrest the crisis, the resulting dismay of investors has been reflected in—among other negative developments—a quickening erosion of market capitalization in the financial sector. In phase one, from August 2007 up to the agreement to save Bear Stearns in mid-March 2008, the monthly loss of global financial sector market capitalization was approximately $150 billion per month. In phase two, from mid-March to mid-September last year, when the Lehman bankruptcy occurred, the loss was $260 billion per month. In phase three, from mid-September to early January 2009, the monthly loss in global financial market capitalization accelerated to a rate of $660 billion per month. The cumulative losses in the market capitalization of the global bank and insurance sectors since August 2007 have, by early 2009, reached $5 trillion. Simultaneously, acknowledged asset write-downs in the global financial sector have totaled over a trillion dollars—with considerably more to come.

At the outset, let me recognize that there can, of course, be quibbles with the dating of crisis "phases" and with estimates of total losses of market capitalization or write-downs at any given point in time. That said, it is very important not to lose sight of the fact that the path of the global crisis and the losses it is visiting on banks and insurance companies—not to mention the global economy—are clear. The time between requisite, ever-larger policy responses to contain the crisis is growing shorter, while attendant losses in the financial sector and the real economy are growing larger.

Phase Four and Beyond

A wave of cautious optimism boosted global financial markets during December and the first few days of the new year. The U.S. S&P 500 Index rose by about 15 percent from the late-November lows below 800 to an early January high above 900. The sharp market sell-off in November, which was tied to frozen credit markets and rapidly deteriorating economic conditions, prompted two major policy "fixes": a rumored Obama administration fiscal stimulus package of up to $1 trillion and a December 16 move by the Federal Reserve

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to a zero interest rate policy and quantitative easing. During December, hopeful markets looked past very bad economic data to the prospect of an economic stabilization by mid-2009 that would help to steady the housing sector and to lessen the underlying negative pressure on the financial sector. Beyond that, plummeting gasoline prices in the latter half of the year added about $200 billion to U.S. household purchasing power and helped to further encourage optimism. The end, early in January 2009, of the brief rise in optimism tied to these events marked an end to the hope that these "fixes" would work and triggered the start of phase four of the crisis.

Many reasoned that since stocks historically rise sharply about six months before a trough in the economy, a mid-2009 end to falling U.S. GDP would mean that late 2008 and early 2009 would be a propitious time to buy stocks and high-grade corporate bonds. Added to the package of U.S. policy responses that appeared in December was a package of about $15 billion of aid to General Motors and Chrysler. Those funds for support of automakers exhausted the $350 billion first half of the $700 billion Troubled Assets Relief Program (TARP) that Congress had passed on October 3, 2008. TARP funds, targeted to support U.S. banks, had been approved by Congress during the panicked response to the bankruptcy of Lehman Brothers that included the demise of the investment banking industry, as Goldman Sachs and Morgan Stanley were forced to become commercial banks. Simultaneously, further losses were reported by Citigroup and AIG.

The TARP response to the turmoil after the bankruptcy of Lehman Brothers constituted a fix cycle within phase three of the credit market meltdown being described here. The TARP program never gained much initial momentum, however, because it had to be implemented through a messy legislative process in Congress. Passage of the TARP required Treasury Secretary Henry Paulson and Federal Reserve chairman Ben S. Bernanke to publicly acknowledge the dire state of the financial sector and the economy. While they were correct to do so, the implementation of the TARP program was not smooth enough to reassure financial markets. Consequently, by mid-November, the selling pressure on financial sector stocks intensified and spread to other sectors of the economy, as it became clear that a failure of TARP to remedy the financial sector problems meant a sharp deterioration in the real economy.

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The idea that averting the bankruptcy of an iconic American corporation such as General Motors was good news and that $13 billion would be enough to do the job did not bear much scrutiny. This became especially obvious as auto sales, at an annual rate of 10.3 million units in December, capped a drop at a 53.5 percent annual rate during the fourth quarter of 2008. In fact, the global financial markets began to sell off again shortly after the very weak auto sales data appeared on January 5, 2009.

Back to the Real Economy

As 2009 began, the paths of financial markets and economic activity were being driven by the effects of a sharp, synchronous collapse in global demand on a scale not witnessed since the Great Depression of the 1930s. The cause of the demand collapse continues to be the worldwide weakness of housing, equity, and corporate debt markets that has, so far, erased about a third of global wealth. Based on data available, it is clear that fourth-quarter 2008 growth rates in major industrial economies will average somewhere around –6 to –7 percent at an annual rate, and there seems little reason to anticipate improvement during the first quarter of 2009. We are poised for another round of the "adverse feedback loop," whereby a collapse in financial assets sharply depresses the economy, which in turn further damages financial assets and thereafter visits even more damage on the real economy.

Notwithstanding the substantial policy measures (especially in the United States) undertaken to offset weakening economic and financial conditions, the underlying problem continues. U.S. house prices continue to fall at a faster pace, having reached an 18 percent annual rate of decline in the fourth quarter of 2008. Policymakers face the dilemma of trying to decide how to contain the crisis without reinforcing the kind of behavior that created the housing bubble in the first place. Some provisions to alleviate the burdens on mortgage holders and, in effect, substantially defer the deterioration of credit conditions that relate to housing will need to be undertaken.

The United States was supported by a robust global economy through the first three quarters of 2008. Without the support of net exports, U.S. growth over the year ending in the third quarter 2008 would have averaged –1.35 percent, even with the boost provided to second-quarter consumption growth by well over $100 billion in direct government transfers to households. Little wonder then that the National Bureau of Economic Research declared late in 2008 that the United States had, in fact, entered recession a year earlier, in December 2007. With Asian industrial production set to drop at a 40 percent annual rate during the fourth quarter of 2008 (contraction of Asian output peaked at a 10 percent annual rate during the Asian crisis of 1997–98), there is a growing risk to global growth and, of course, to the support from net exports to U.S. growth.

While markets were braced for weaker U.S. growth in the fourth quarter, the numbers that actually appeared early in January still came as a shock. The December employment report was disastrous. Private payrolls fell by 531,000, while the figures for previous months were revised downward by another 117,000. This news, coupled with a rise in the unemployment rate, from 6.8 to 7.2 percent, signaled an unexpectedly weak path for the U.S. economy going forward into 2009. Total hours worked declined at a 7.8 percent annual rate during the fourth quarter—a steep acceleration downward from the 2.1 percent annualized contraction in the third quarter. The details of the employment report were, if anything, worse than the headline data. The report solidified the view that fourth-quarter U.S. growth would be sharply lower, at a –6 percent annual rate that could worsen in the first quarter of 2009.

The sharply deteriorating employment picture along with huge wealth losses and an absence of available credit heavily depressed retail sales and consumer spending at the end of the fourth quarter, notwithstanding the substantial boost to disposable income from lower gasoline prices. For the fourth quarter as a whole, retail sales contracted at a 28.3 percent annual rate. Even excluding the big drop in retail sales (aside from gasoline), the rate of contraction was 11.2 percent. The result of the drop in the nominal value of retail sales will be an almost unheard of drop in nominal consumption. A drop in real consumption is highly unusual, not having been seen since the early 1980s. Even then, nominal consumption rose because the prices of consumption goods were rising as well. Now, with the deflationary pressure emerging in a sharply weakening global economy, it appears that nominal consumption could have fallen at a 10 percent annual rate in the fourth quarter—which would be the first negative reading since the first quarter of 1951. Of course, plunging nominal consumption signals sharply weaker corporate profits since the overall growth of demand for goods and services is shrinking at a rate that makes expanding profits virtually impossible.

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While extraordinarily weak fourth-quarter data were emerging for the global economy and the U.S. economy as well during the second week of January, global banks began to report larger fourth-quarter losses. Among the largest was an $8.3 billion loss announced by Citigroup as it moved to split itself into two banks in an effort to dismantle what had become an unmanageable financial conglomerate. Bank of America announced a $2.4 billion loss, while the U.S. government provided a $20 billion capital injection and $118 billion loss guarantee. Bank of America disclosed that Merrill Lynch, which it acquired late in 2008, had suffered a $21.5 billion operating loss tied to a plunge in the value of mortgage-backed assets. Somewhat ironically, as Citigroup moved to dismantle its unwieldy, too-big-to-manage structure by proposing to sell off its Smith Barney brokerage arm, Bank of America simultaneously received a large government subsidy to proceed with its acquisition of the retail equity brokerage Merrill Lynch. The disparity between these policy moves—with Citigroup being broken into smaller pieces while Bank of America received a government subsidy to add Merrill Lynch to its mix—underscored the sense of disorder in financial markets and the ad hoc response of policymakers and banks to that intensifying disorder.

Phase Four Fixes

Policymakers worldwide are promulgating a wide range of steps to contain the financial crisis and its negative spillover to economic growth. The intensifying financial distress and economic weakness in the United Kingdom has led to another round of measures from the Bank of England and the UK Treasury, including an additional £100 billion capital injection into the banking system and a new program to empower the Bank of England to buy a wide range of asset-backed securities with support from the UK Treasury. Still, perhaps the most representative range of measures is under consideration in the United States in an effort to make phase four of the global financial economic crisis the last phase. Bernanke set the tone for the next set of policy responses in his January 13 Stamp Lecture at the London School of Economics. His remarks echoed the conclusions reached in an International Monetary Fund paper released late in December on "Fiscal Policy for the Crisis," which argued that in a financial crisis the experience of Asia and Japan demonstrated that a massive financial rescue plan must be in place if fiscal stimulus is to be effective in helping to boost overall spending. "In my view," Bernanke said, "fiscal actions are unlikely to promote a lasting recovery unless they are accompanied by strong measures to further stabilize and strengthen the financial system. History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively."[2]

Bernanke also outlined an important distinction between quantitative easing, whereby the central bank adds aggressively to the quantity of bank reserves in hopes of stimulating bank lending, and a "credit easing," whereby the Federal Reserve "focuses on the mix of loans and securities that it holds and on how this composition of assets affects credit conditions for households and businesses."[3] In effect, the credit easing approach has the Fed undertaking direct purchases of bad assets from the banking system to enable banks to move ahead as credit suppliers to households and businesses without being burdened by the need to cut leverage in order to deal with the risks tied to bad assets.

Bernanke appears to be suggesting consideration of the creation of a "bad bank" that buys up troubled assets from the banking system much as the Resolution Trust Corporation was capitalized to buy up the bad assets from the savings and loan institutions in 1989. The questions that remain are: How large does the fund need to be? Where does it obtain the equity capital it needs? And at what price does it acquire troubled assets from the banks? Under this type of plan, taxpayers, who in effect provide the capital for the bad bank, enjoy the gains that accrue if and when the value of the assets recovers after the financial crisis is over and the economy recovers as well.

The source of equity capital for the bad bank is currently problematic. The second half of the TARP, along with the Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) aimed at buying commercial paper, might be combined to capitalize such a bank. Congress, however, unhappy with the disposition of the first half of TALF largely aimed at recapitalizing banks, now wishes to switch the focus of TARP funding from support of Wall Street to support of Main Street. On January 12, 2009, a letter from incoming National Economic Council director Lawrence Summers to the congressional leadership outlines the proposed Wall Street to Main Street shift for remaining TARP funds.

The Road Ahead

Bernanke's emphasis on the intense need for a financial rescue to enhance the impact of fiscal stimulus is well grounded in history. Currently, the fiscal stimulus package is estimated at $825 billion over two years with $275 billion in tax relief included. The tax relief of about $140 billion a year would probably provide an annual stimulus of somewhat less than a percentage point. The remaining $275 billion per year of so-called fiscal stimulus includes a substantial portion of outlays that replace expenditures by state and local governments and some measures such as aid for unemployed and needy workers and education that, while urgently needed and perhaps good long-term investments, will not provide much-needed stimulus to aggregate demand. On the whole, the $825 billion fiscal stimulus package will provide net stimulus of less than 2 percent of GDP per year, probably only about 1 percent of GDP during 2009. That is considerably less than the projected expenditure drop of about six percentage points of GDP during 2009 tied to a rise in the savings rate and to sharp reductions in consumption and investment spending because of weak earnings and wealth losses. If the financial sector remains out of operation, the impact of the fiscal stimulus will be even less.

We must hope that the financial rescue entailed by the credit easing approach Bernanke articulated early in January will mark a turn toward a proactive policy response on a scale sufficient to truncate the intensifying and accelerating cycle of financial instability that has been accompanied by ever-rising wealth losses. If, over the coming months, a series of steps can be undertaken to contain the financial crisis by re-enabling the banking system to provide credit to households and firms, hopes for a stabilization of output by early 2010 may yet be realized.

Notes

1. "Four Stages of Financial Meltdown," *Financial Times*, January 17–18, 2009.

2. Ben S. Bernanke, "The Crisis and Policy Response" (Stamp Lecture, London School of Economics, London, January 13, 2009), available at www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm (accessed January 29, 2009).

3. Ibid.