THE WALL STREET JOURNAL.
EUROPE

News in Depth -- The Financial Crisis: As financial crisis spreads, few good scenarios are in view --- The most likely outcome is a recession along with a protracted period of tight credit

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2,417 words
29 September 2008
The Wall Street Journal Europe
WSJE
14
English
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THE WALL STREET turmoil is shaking an already-weakened U.S. economy and could hit households and businesses in the form of fewer loans and higher interest rates in the months ahead -- in turn sending unemployment higher and corporate profits lower.

Economic data released Thursday show the stress in the economy leading up to the crisis and hint at how it may have gotten worse since. Gross domestic product grew at a 2.8% annualized pace in the second quarter, compared with the original 3.3% estimate. Demand for manufactured goods fell sharply in August as new-home sales slid to their lowest monthly level in 17 years. And in the week ended Sept. 20, new unemployment filings hit the highest level since just after the 9/11 terrorist attacks.

U.S. leaders hope the government's massive interventions, plus plans for a big bailout now being negotiated, will soften the blow. The economy also is running on a reassuring quarter-century path of mostly sustained growth that could reassert itself.

But ripple effects from a worsening credit crunch are already making their way from Wall Street to Main Street. General Electric Co. kicked off what could be a parade of profit warnings on Thursday. Many companies have seen their borrowing costs rise in the short-term commercial-paper market.

History and a close look at recent data suggest the economy could travel any of four possible routes through the financial crunch. The most likely scenario is a recession marked by a protracted period of tight credit. But three other scenarios -- a dangerous run on the dollar, Japan-style deflation or surprising economic resilience -- are also within the realm of possibility.

Here's a deeper look at how the economy could play out in the months ahead:

Credit crunch

Two related factors are at the heart of the U.S. economy's woes -- a housing downturn and a credit crunch. Moody's Economy.com estimates that banks made 15 million sketchy mortgage loans from 2004 to 2007 and that ultimately 10 million of those will default. The defaults are forcing down home prices and spurring banks to stiffen their lending standards, contributing to more defaults, in a downward spiral.

Financial institutions also borrowed too much. Financial-sector debt outstanding grew to $16 trillion in 2007 from $10 trillion in 2002. Profits in the sector also grew strongly for a while. Now they're going in the other direction, making it harder for financial firms to finance this overhang of borrowing and forcing those firms to shrink.

"This isn't just about households. The problem is the financial sector overextended itself too, and thus the process we're going through is not just about homeowners defaulting on their mortgages. It is about financial institutions not being able to sustain their liabilities," says Peter Fisher, co-head of fixed income at BlackRock, the asset-management firm. If the banks aren't growing, "then credit can't grow. That is the driving force here."

According to Federal Reserve statistics, household borrowing slowed to a 1.3% annual growth rate in the second quarter, after increasing at a double-digit pace for much of the decade. Financial-sector borrowing grew at a 6.6% rate in the second quarter, compared with a double-digit pace for much of the decade. Credit may slow much further, providing less oomph for consumer and business spending.

International Monetary Fund economists studied 122 recessions around the world since 1960 and found that the ones associated with housing busts or credit crunches were deeper than others.

In a typical recession among the 21 countries they studied, the national economy contracted by 2%. In the U.S. today, that would be equivalent to a decline about $230 billion of goods and services, adjusted for inflation. In severe recessions, the contractions averaged 5%, which in the U.S. would be almost $600 billion in lost output. Unemployment rates rose 0.6 percentage point in typical recessions and 1.7 percentage points in severe ones, according to the study by the IMF economists, Stijn Claessens, Ayhan Kose and **Marco Terrones**.

By most technical definitions of a recession, the U.S. still isn't in one. The simplest definition is two straight quarters of contraction in gross domestic product. But the U.S. unemployment rate, at 6.1%, has risen 1.7 points since early last year and looks sure to go higher.

The recessions the IMF studied lasted almost a year, on average, but the severe ones played out more slowly, lasting a quarter longer.

Another characteristic of downturns driven by tight credit, says Carmen Reinhart, a University of Maryland professor who has studied eight centuries of financial crises, is that government debt tends to soar, as safety nets and bailouts kick in. In South Korea, domestic government debt amounted to less than 10% of GDP before the 1997 financial crisis, but afterward stood at 42% of GDP, she says. Japan's increase during its long 1990s downturn was even bigger.

In the U.S., government debt is still relatively low as a percentage of GDP, 61% in 2007, compared with nearly 200% in Japan in recent years, according to the IMF. Ms. Reinhart says U.S. debt is sure to soar in the aftermath of this crisis. That could constrain future administrations as they seek to tackle budget problems such as Social Security, Medicare and Medicaid.

Dangerous dollar

Some economists are discussing a worse scenario, albeit one they deem unlikely at this point: Foreign investors' confidence in the U.S. financial system could diminish and they could curtail their large investments in U.S. dollar assets such as Treasury bonds and U.S. stocks. These investments help to finance the gap between what the country spends and what it saves.

One sign of the U.S.'s vulnerability is its current-account deficit, a broad measure reflecting how much more Americans import than export. That deficit has been shrinking, but at 5.3% of GDP last year, it still was big by international standards. It makes America dependent on foreigners' appetite for U.S. assets, since those flows finance the deficit.

Foreign central banks take the dollars from their exports to the U.S. and recycle a great many of them by buying Treasury bonds and other debt. As of 2007, foreigners owned approximately 57% of U.S. Treasury bonds, a record. They also owned about a quarter of corporate debt and a fifth of so-called "agency" bonds issued by institutions like Fannie Mae and Freddie Mac.

If foreigners stopped buying U.S. assets, or started selling them, the dollar would fall and U.S. interest rates would jump, squeezing the economy further.

In the financial crises that shook emerging markets from Thailand to Russia in 1997 and 1998, sudden cessations in foreign investment flows were common. The risk is that foreign investors could get so worried about the prospects of the U.S. economy that they would feel less comfortable investing large sums in America.

"If we were an emerging market, the exchange rate would be down 70% and interest rates would be up at 25% -- that's what a crisis looks like," says Kenneth Rogoff, an economics professor at Harvard University.

He and many other economists don't believe that will happen. Indeed, so far, rather than retreating from assets like U.S. Treasurys, investors around the world have flocked to them, indicating they continue to see U.S. government debt as a haven in an uncertain world. Foreign central banks, in particular, have shown no sign of deserting Treasurys.

Japan-style deflation

For the past year, many investors have been preoccupied with inflation. Driven higher by fuel and food prices, the consumer-price index in July stood 5.6% higher than a year ago, the highest inflation rate in 17 years.

That could reverse. In the past, credit crises have been associated not with inflation but deflation, in which prices don't just rise less rapidly -- that's called disinflation -- but actually fall.

Deflation brings its own set of woes. If people and businesses expect prices to fall, they have an incentive to put off spending, further weakening the economy. Deflation is a tricky problem to fight. While the Fed can hammer inflation by pushing short-term interest rates ever higher, after it cuts the overnight-lending target rate to zero, it can cut no more. In Japan, where prices fell 3.5% between 1998 and 2005, the government spent years fighting deflation with zero-percent interest rates, to little effect.

The U.S. could stumble into deflation because of the way credit crises play out. When borrowers run into trouble, they need to raise money. They sell assets, forcing asset prices lower. A slowing economy also puts downward pressure on prices. Higher unemployment, for instance, means there is more slack in the labor market, giving workers less leverage to push for more pay.

Signs of easing inflation pressures are starting to show up. An example is the past few months' decline in many commodities, like oil, down on Friday to $106.96 a barrel from its July high of $145.29. Goldman Sachs economist Andrew Tilton calculates that if crude fell to $80 and food-price inflation subsided, by next July overall consumer prices could be below their year-earlier level.

For deflation to become a real problem, it would have to infect more than just volatile food and energy prices. At the moment, that doesn't seem likely, because prices outside of these sectors have remained reassuringly stable in the past few years.

But financial markets are sending their own worrying signals. Yields on short-term Treasury bills have dropped sharply, briefly almost touching zero. The cause is the rush among nervous investors to get into less-risky assets. The yields could rise as investors become calmer. Still, such extremely low yields on low-risk assets could also be a signal of fast-declining inflation pressures.

As Federal Reserve Chairman Ben Bernanke pointed out in 2002 -- which was the last time the Fed was worried deeply about deflation -- there are many steps policy makers could take to head off the problem in addition to interest-rate cuts. In an extreme scenario, the government could lower taxes or ramp up spending. The Fed could also buy the bonds issued to finance such moves, which is tantamount to printing money and handing it out to households.

"The chances are really remote that we get into a bad deflation scenario," says Michael Bordo, a Rutgers University economist. "The danger sign is if the bailout plan doesn't work and banks continue to stop lending and people cut back on their spending and firms go bankrupt and people go bankrupt. In that situation, then prices are going to start to fall."

Surprising resilience

The disaster scenarios are scary, but maybe no more plausible than a happy ending.

Since the deep downturns of the early 1980s, the U.S. economy has just gone through a 26-year period with only two short and relatively shallow recessions, despite two wars in Iraq, a technology-stock crash, a commercial-real-estate bust, terrorist attacks, an oil-price surge and many other shocks.

What explains the resilience? Policy makers have reacted rapidly to changing circumstances. After stocks crashed in 1987 and began a long slide starting in 2000, Alan Greenspan, then Fed chairman, moved fast to cut short-term interest rates. In the current financial crisis, his successor, Mr. Bernanke, a student of the Great Depression, was quick to see risks to the economy and cut rates in a year's time by 3.25 percentage points to 2%.

As a result, although loans may be harder to come by, interest rates on some loans haven't risen as they would in a very severe credit crunch because the Fed has been leaning heavily in the other direction.

On 30-year fixed-rate mortgages that meet Fannie Mae's and Freddie Mac's criteria, the average interest rate was 6% as of Sept. 19, down from 6.4% a year ago, according to HSH Associates. Rates on larger "jumbo" loans, at 7.36%, haven't risen much either. Rates on home-equity lines of credit have dropped because of declines in banks' benchmark prime rate.

The U.S. economy has other forms of insulation. Some countries facing economic crises in the past have had a hard time digging out because their corporations or governments had borrowed in a foreign currency, namely, the U.S. dollar. When their currencies declined in value against the dollar, these debts became more expensive to repay.

Not so the U.S., which borrows in its own currency. While the dollar has fallen in value against other currencies over a period of years, that hasn't made U.S. debts to foreigners more costly to pay back.

Meanwhile, in other ways, the dollar's decline has helped the economy of the U.S., making its exports more affordable abroad. Exports in the second quarter grew at a 13% annual rate, and the improving U.S. trade position accounted for most of the economy's growth.

Technology-driven productivity gains are also an important source of U.S. strength. During the 2001 recession, many companies insulated themselves by squeezing more output from their existing work forces. It proved painful for workers, who suffered through a protracted job downturn, but set the stage for a profit boom that helped to drive the economic recovery.

Productivity is rising again now, as well. In the second quarter, output per hour was up 3.4% from a year earlier, the best showing since early 2004. That has made it easier for U.S. companies to keep clawing out profits by squeezing costs, despite the economy's problems.

And while households and financial firms have borrowed aggressively, corporations haven't loaded themselves up with too much debt. Corporate borrowing outside of the financial sector has grown at a relatively modest annual rate of 6% so far this decade. Because they aren't overburdened by debt, companies are in a better position to manage a downturn.

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