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THE PROBLEM FOR MAIN STREET

WHY ECONOMIC STABILIZATION IS NECESSARY

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INTRODUCTION

To many, the major economic proposal facing Congress this week seems to have little connection with the realities of their day-to-day lives. In part, that is because the severe disruptions are occurring in a portion of the financial system that is invisible to most Americans: the credit markets.

In evaluating the health of U.S. financial markets, observers often look to the Dow Jones Industrial Average or the Standard and Poor's 500. Most Americans have a fairly good idea about the stock market, because many are invested in equities through individual retirement accounts or 401(k) plans. Arcane terms such as "swaps," "spreads," and "commercial paper" are foreign to most Americans; but they are key indicators of the health of the credit market – and they are currently flashing red. This problem is serious because the credit market, at its basic level, is the *circulatory system* of the economy. Its smooth functioning is vital for businesses to fund their day-to-day operations, and for consumers to buy cars or obtain student loans.

Now that credit system is paralyzed. Banks are not lending to one another because they do not trust the financial health of their counterparties, and they feel the need to conserve capital to weather the next potential crisis. Investors, meanwhile, are shunning most securities except those with little or no risk. Without trust, confidence, or a tolerance for risk, markets in the U.S. are breaking down.

The tight squeeze in credit markets, if left unaddressed, has several potential ramifications. It could impair the ability of companies to meet payrolls or to finance expansions, leading to more job losses; it could make it increasingly difficult for prospective home buyers to obtain mortgages; and it could block students' access to college loans. In short, what critics deride as a huge "bailout for Wall Street" in fact aims at preventing painful consequences on Main Street – consequences that, at worst, could cause a deep and long recession. Separating Wall Street and Main Street is a false dichotomy; they are two sides of the same coin.

Throughout the year, the Federal Reserve and the Department of the Treasury – aware of this potential fallout – have sought to treat, one by one, the financial market side of the problem, such as the failure of major banks, and the near collapse of the mortgage giants Fannie Mae and Freddie Mac, among others. But difficulties have continued to mount, suggesting the need for a

broad, comprehensive approach. The choices are not appealing. They entail a huge government intervention in the economy, and large potential costs to taxpayers – made all the more distasteful by the widely shared impression that Congress is just saving imprudent or unscrupulous investors from the problems they created with taxpayers' dollars. But a failure to act invites a far greater risk to U.S. capital and credit markets that in the end will punish all U.S. businesses and families.

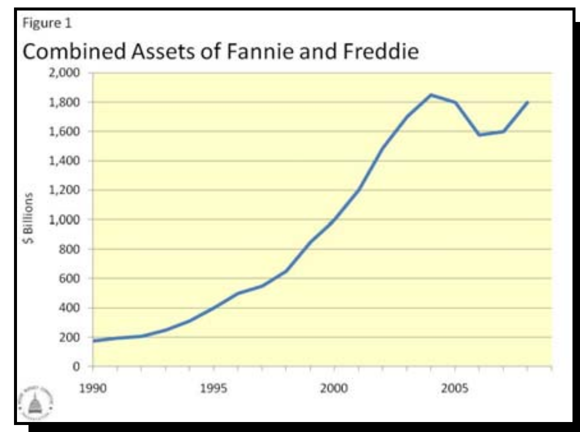
This paper traces the causes and symptoms of the problem; the signs of a potential recession in the U.S. economy; and some of the effects of the credit crisis already are being felt in the day-to-day economic life of Americans.

THE KEY CAUSES AND SYMPTOMS

To a large extent, the U.S. economy operates on the constant and circular flow of funding from lenders to borrowers. This dynamic, for instance, provides businesses with working capital to meet day-to-day expenses (such as payrolls) or finance longer-term expansion plans. When the lending arteries become constricted, as they have, they choke off the flow of credit and, in turn, weaken the economy's fundamental health. The factors contributing to these credit problems are interrelated and tend to feed on one another. Among the main ones are the following:

Roots of the Problem. The current crisis developed over many years. The Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long earlier this decade. Over the same period, lending standards on mortgage loans loosened. Subprime and near-prime loans jumped from 9 percent of securitized mortgages in 2001 to 40 percent in 2006. These mortgages required virtually no proof of income and little down payment. Meanwhile, mortgage originators, working alongside investment banks, packaged these dodgy home loans into complex securities and sold them to the financial market. Investors and credit rating agencies misjudged the risk of these securities. As long as the housing prices kept rising at double-digit rates, this situation was stable. But this deck of cards was poised to collapse when home prices (the underlying collateral for this system) declined.

Government-Sponsored Bad Actor. Standing at the center of this system were two huge government-chartered agencies: the Federal National Mortgage Association [Fannie Mae] and the Federal Home Loan Mortgage Corporation [Freddie Mac]. They stoked the market by adding liquidity and signaled to everyone that the casino game of cheap money, low risk, and ever-rising home prices would last. With their implied Government backing, they secured cheap funding to build up massive investment portfolios of mortgages and mortgage-backed securities to enrich their shareholders. Since 1990, their portfolios have grown tenfold, from $135 billion to $1.5 trillion (see Figure 1). Fannie's and Freddie's large purchases of mortgage-related securities, many of which were near-prime and subprime, put the government stamp of approval on this system, and encouraged risky behavior in the market.

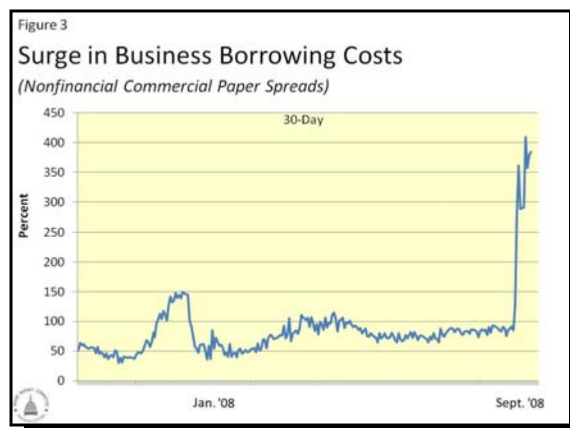


In fact, data show that between 2005 and 2007, roughly 50 percent of Fannie's and Freddie's mortgage purchase had subprime characteristics. According to the American Enterprise Institute [AEI], Fannie and Freddie became the largest purchasers of the higher-rated (AAA) tranches of the subprime pools that were securitized by the market. AEI scholars conclude that "without their commitment to purchase the AAA tranches of these [subprime] securitizations, it is unlikely that the pools could have been formed and marketed around the world." In other words, Fannie and Freddie played a pivotal role in the growth and diffusion of the mortgage securities that are now crippling the U.S. financial system.

Falling Home Prices. The party ended when home prices began to decline (see Figure 2). Many borrowers were left holding mortgages that exceeded the value of their homes, and some began to default (more than 25 percent of subprime mortgages are now delinquent). Others are losing large sums if they choose to sell their homes. For most Americans, their home is their principal investment, so these losses – or even the fear of them – undermines their basic confidence in the economy and their prospects for the future.

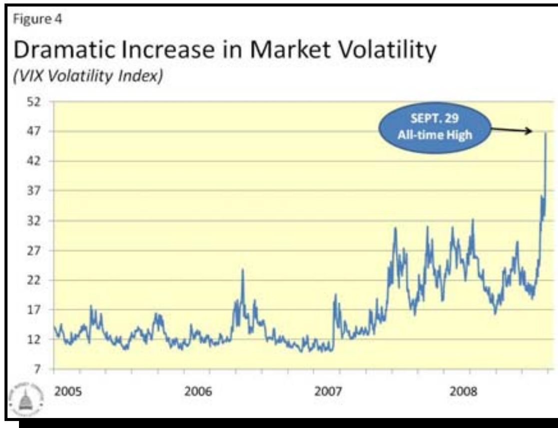
Mortgage-Related Securities. Rising mortgage delinquencies sparked sharp declines in "mortgage-backed securities" – financial instruments based on mortgages – which, for various reasons, have become the largest segment of the U.S. bond market (24 percent). Financial institutions are suffering sharp losses on these assets. These securities have infected the financial system because they have sharply declined in value and can be sold only at fire-sale prices. They have undermined the confidence and trust at the heart of the credit system.

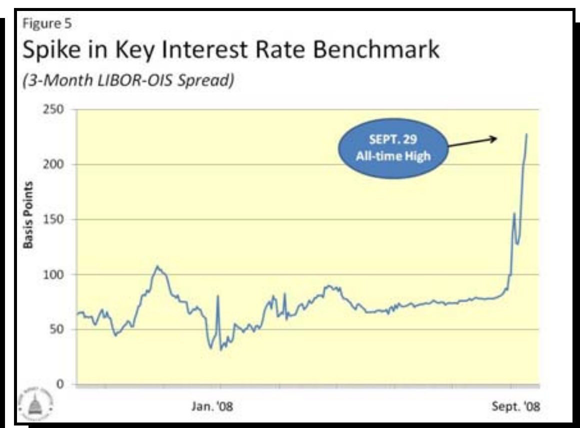
Strain in Commercial Paper. "Commercial paper" provides a short-term lending mechanism for businesses, and a safe haven for large institutional investors such as money market funds. These loans – which provide working capital to businesses to meet payrolls and finance expansions – are under unprecedented strain. The cost of a 30-day loan for a non-investment-grade business has doubled over the past 2 weeks, while the risk spread on this debt has jumped to 400 basis points, paralyzing the market. If this paralysis is allowed to continue, businesses will contract, workers will lose jobs, and near-term recovery will be more difficult to achieve (see Figure 3).



The Volatility Index. The Chicago Board Options Exchange [CBOE] volatility index, based on prices of financial options, is a proxy for investor fear and uncertainty, and often is referred to as the "fear index." This measure, also known as VIX, has risen sharply in recent weeks, and earlier

this week reached its highest level ever – higher than after 9-11. With this level of fear in the market, many investors are moving out of "safe" funds and into cash; and some are even worried about their bank deposits (see Figure 4).





Rising Bank Lending Costs. In this climate, banks have grown fearful of lending to one another, as reflected by a benchmark known as the London Interbank Offered Rate [LIBOR], which has risen sharply, to record levels (see Figure 5). The rise in the LIBOR further threatens corporate loans, mortgages, and student loans, which frequently are pegged to this rate. The LIBOR spread signals the danger of credit markets seizing up.

A Decline in Money Market Funds. Money market funds are high-quality, low-risk instruments that are invested in cash or cash-equivalent securities, such as commercial paper. But in September, shares in the Primary Fund dropped to below $1 each, to 97 cents. This phenomenon, called "breaking the buck," means holders of these instruments will receive less from them than they invested. This occurred because the Fund held $785 million in the debt of Lehman Brothers Inc., and was forced to redeem them when Lehman declared bankruptcy. This event further threatened confidence in U.S. financial markets, further clogging the flow of lending.

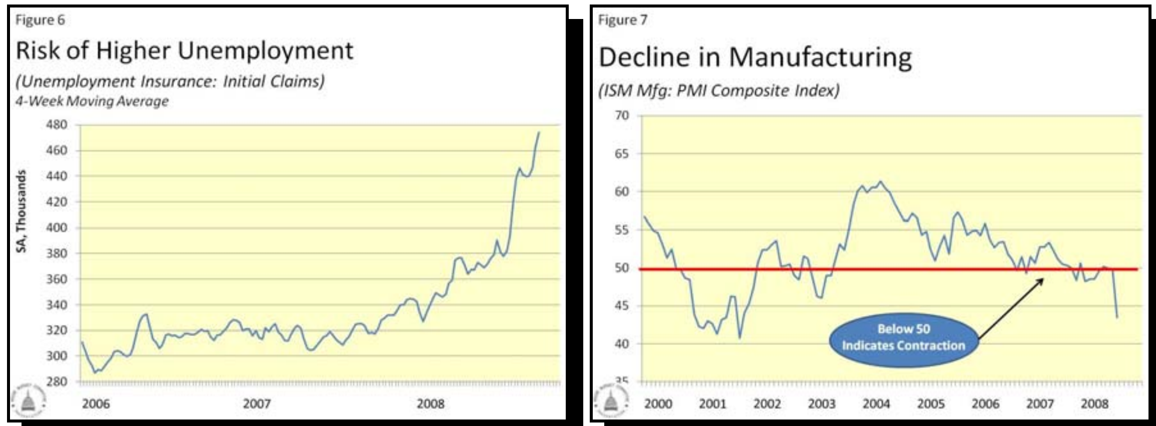
RECENT SIGNS OF RECESSION

The real-world effects of these trends can be seen in various economic indicators, such as these:

Job Losses. The economy lost 159,000 jobs in September – the ninth straight month of declines – bringing total job losses for the year to 760,000. The unemployment rate remained at a 5-year high of 6.1 percent. These figures, another clear indication that the credit crunch is leading to more layoffs, were presaged in recent weeks by a surge in first-time claims for unemployment insurance, which reached a 7-year high of nearly 500,000 (see Figure 6 on the next page).

Manufacturing in Decline. The credit crunch is not just a problem for financial institutions; it is beginning to affect brick-and-mortar companies as well as the manufacturing and construction industries. The Institute of Supply Management [ISM] Manufacturing Index, for instance, fell to 43.5 this month, the lowest level since late 2001 (see Figure 7 on the next page). Readings below 50 in this index reflect contractions in the manufacturing sector.

Consumers Not Spending. Consumer spending accounts for two-thirds of gross domestic product. But in the current environment, consumers are either afraid to spend, because they are concerned about the economy and their jobs, or they cannot get access to reasonably priced loans to make a big purchases such as cars or homes. Auto makers, for instance, have been hit hard by the credit crunch and its impact on consumers: monthly auto sales in September dipped to their lowest level since mid-1992.



HITTING MAIN STREET

These factors translate into tangible effects in the lives of Americans living far from the New York Stock Exchange. Below are some anecdotal examples, drawn from various media accounts, of small and large businesses experiencing financial and operational problems during the current credit crunch.

- "Our concern is with what would happen without the rescue plan, if capital does tighten up and continues to be hard to come by," said John McEleney, who runs two dealerships in Iowa and is the incoming chairman of the National Automobile Dealers Association. The association reports 600 dealerships nationwide have closed this year. "The auto financing model could struggle, whether it's customers financing the vehicle or dealers financing their inventory."

  Auto dealerships are facing rising interest rates because they heavily relied on Wachovia and other big Wall Street institutions to borrow money to refresh their inventories of vehicles. Rates on these loans have been soaring and contributed to the collapse of Bill Heard Enterprises, which called itself the nation's largest Chevrolet dealership. Earlier this week, the dealership filed for bankruptcy citing sagging sales and the tumultuous credit markets. The Georgia-based company had dealerships across the South that sold an estimated 40,000 vehicles a year. The shutdown caused the layoffs of 3,200 employees. (*The Washington Post*, 1 October 2008)

- More than half of U.S. adjustable rate home loans are tied to LIBOR, so a recent increase in this benchmark rate mean monthly mortgage payments will rise for affected homeowners if the rise is sustained. A typical adjustable rate home loan will adjust based

on the 6-month LIBOR, plus 2 to 3 percentage points. Plus, many home equity lines of credit, small business loans and student loans also use LIBOR as an index. Student loans, for example, can be set based on the 3-month LIBOR rate plus, say, four percentage points or the one month LIBOR rate, plus 9 percentage points. Because LIBOR's elevated state has pushed up rates on adjustable mortgages as well as rates on many commercial loans, that has blunted the effectiveness of the recent interest-rate cuts enacted by Federal Reserve policymakers in an effort to stimulate the economy. It also means consumers, who account for more than two-thirds of total U.S. economic activity, can find their access to credit restricted. (The Associated Press, 30 September 2008)

- Two vital forms of credit used by companies — commercial and industrial loans from banks, and short-term "commercial paper" not backed by collateral — collectively dropped almost 3 percent over the last year, to $3.27 trillion from $3.36 trillion, according to Federal Reserve data. That is the largest annual decline since the credit tightening that began with the last recession, in 2001.

  Drew Greenblatt, president of Marlin Steel Wire Products, figured it would be easy to get a $300,000 bank loan to finance a new robot for his factory in Baltimore. His company, which makes parts for makers of home appliances, is growing and profitable, he said. His expansion would add three new jobs to an economy hungry for work. But when Mr. Greenblatt called the local branch of Wachovia – the same bank that had been aggressively marketing loans to him for years – he was distressed by the response. "The exact words were, 'We're saying no to almost everybody,'" Mr. Greenblatt recalled. "This is why God made banks, for this kind of transaction. This is going to slow down the American economy."

  For the last 6 months, Saul Epstein has been trying in vain to get a $2 million line of credit for his company, Global Harness Systems. The company, based in Bala Cynwyd, Pa., has a factory in Mexico, where it makes parts for engines. The factory gets paid for its wares weeks after they have shipped, necessitating credit to finance the upfront costs of production — raw materials, labor and transportation. Mr. Epstein figured that getting a loan would be easy. Since he became chief executive last year, Global Harness has gone from break-even to profitable. Sales should reach $20 million this year, up from $17 million last year, he said. But in this new era of caution, banks are focused on the fact that Global Harness lost money in 2005. "They keep saying, the way the times are, we need a longer track record," Mr. Epstein said. Mr. Epstein, forced to limit his production to what he can finance with his existing cash flow supplemented by his own money, has been tightening credit himself: He has been turning down orders from companies with any whiff of financial troubles, lest his company fail to get paid. "The same way the bank is hesitant to lend to me, you're concerned about taking on a customer that might go into bankruptcy," he said.

  George Rosero, president and chief executive of Atlanta Pediatric Therapy, has been trying for more than a month to increase his roughly $500,000 credit line to about $1 million. His company, profitable for the last two years, offers therapy to children with speech and physical impediments, he said. Mr. Rosero aims to expand by adding four sales people. He wants to buy new software to better manage communications with patients and hire a consultant to improve the work environment. All of that is on hold.

"Three or four years ago, I could just make a phone call and get an increase," Mr. Rosero said. "Now, they're asking me for a lot more information." (*The New York Times*, 28 July 2008)

- General Electric last week suspended its stock buyback, shifting capital to protect its dividend and AAA credit rating. The company said it has slashed its commercial paper to below $90 billion, a goal that Chief Financial Officer Keith Sherin announced last week to investors. (Bloomberg, 1 October 2008)

- On Monday, in a move that left colleges scrambling, Wachovia said it was limiting the access of nearly 1,000 colleges to $9.3 billion the bank has held for them in a short-term investment fund.

  So what's next for loan-seeking law students? The NLJ [*National Law Journal*] reports that, while the credit crisis won't eliminate the type of government-backed loans that many laws students rely on to finance their educations — presumably, those subsidized and unsubsidized government loans that, in our day, amounted to about $18,500 per year — the price of private loans is likely to go up.

  Because banks are doling out less money to lenders, private loans are getting harder to come by, New York Law School Dean Richard Matasar, who is also chairman of the board of directors of education lender Access Group, told the NLJ. "It's a time for caution," said Matasar, who also cited an uncertain 2009 job market. "It's a time for students to plan well for how much debt they are taking on and how they will pay for it," he said.

  While the financial future may look a bit bleaker for some soon-to-be law school graduates, Matasar told the NLJ that increased enrollment in law schools overall could be a positive side effect of the slowing economy. Many people look to higher education as a way to wait out tough economic times and bad employment markets, he said. (*The Wall Street Journal*, 2 October 2008)

NEXT STEPS

These problems will generate a strong impulse in some quarters to expand government's role in the economy. But the current economic turmoil was not caused by a failure of the free market system. It is the product of excessively loose monetary policy; of the abuse by Fannie Mae and Freddie Mac of their special financial status; and of a failure of transparency and accountability in financial products that were traded as safe securities when in fact they were neither safe nor high-yield products.

The correct response is not more government, but a more responsible pursuit of the free-market model – one with appropriate regulatory oversight and transparency, and sound monetary policy – which has made the U.S. economy the most prosperous in the world.

Prepared by . . . . Timothy P. Flynn, Chief Economist