

ECONOMIC NEWS UPDATE

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It All Depends on What the Meaning of “It” Is

The money men say it is over. The economists say it has just begun. And the politicians are loving every minute of it. Perhaps it all depends on what the meaning of the word “it” is.

To Treasury Secretary Hank Paulson “it” is the credit crunch. “I am encouraged. I am feeling better about the markets. In terms of the capital markets, I believe we are closer to the end than the beginning.... The worst is likely to be behind us.” Before you attribute that to the usual cheer-leading expected of a Treasury Secretary, consider the words of legendary investor Warren Buffett, “The worst of the crisis on Wall Street is over.”

What these money men have in mind is that the banking system is gradually deleveraging -- writing down the rotten paper on and off its balance sheets, and replacing it with massive amounts of new, real capital. Some comes from sovereign wealth funds, although the managers of these enormous piles of cash are somewhat more cautious now that they have seen

the value of some of their early forays into such as Citigroup dwindle. Some of the new capital comes from what are called ‘bottom fishers’ -- investors who are willing to buy some of the dicey IOUs from banks at a healthy discount. All in all, U.S. financial institutions so far this year have raised \$46 billion in preferred stock, compared with \$27 billion in the same period last year, and \$41 billion in convertible and common stock, ten times the sum raised in the first five months of last year. Vince Breitenbach, head of credit research at Barclays Capital put it this way to The Wall Street Journal, “It’s a big world and what we have found is that the markets are truly global, and there is a wealth of opportunity to raise money.”

One example of the ability of troubled banks to get their hands on new capital: asset manager BlackRock paid UBS \$15 billion for a portfolio of subprime mortgages that was on the bank’s books at a value of \$20 billion -- a 25% discount. In addition, the troubled bank raised billions from Singapore’s

sovereign wealth funds, rich Saudis, and its own shareholders. Tough medicine, but at the end a healthier bank.

Not all observers agree with Paulson and Buffett. Consultants Capital Economics advise their clients, "Far from beginning to ease ... the credit crunch is spreading [from] ... real estate loans [to] ... commercial and industrial loans and credit card lending...". Loan officers at the Fed concur; they point to tightening loan standards that are "close to or above historical highs for nearly all loan categories."

All of these experts are correct. Paulson and Buffett are encouraged by the fact that the difference between interest rates paid on risk-free government IOUs and riskier bank-to-bank loans has declined sharply, suggesting that banks now think it is less risky to lend to one another than it was a few months ago. They also must find it encouraging that the gap -- or "spread", to use money-market jargon -- between mortgage-backed securities and ultra-safe Treasuries has fallen in half. Others find it more impressive that the risk differential between safe Treasuries and risky paper remains twice as high as during normal times.

Conclusion: if the "it" is the credit market, it is on the way to a more normal condition, but still not out of the woods. The other "it", the one that grabs the attention of economists, is either getting worse or bottoming out. Take your pick. New mortgages are hard to come by; defaults are rising (four million homeowners are behind on payments), as are foreclosures (likely to total two million this year), inventories of unsold houses are rising, and prices, which by some estimates are now almost 13% below last year's level, continue to fall. "The rapid decline in house prices

shows no sign of abating," say Jan Hatzius and his economist-colleagues at Goldman Sachs.

But a bit of perspective is useful. There are 80 million houses in America. Twenty-five million are owned mortgage-free. Of the 55 million homeowners with mortgages, about 50 million are up-to-date on their payments. So some 75 million of the 80 million homeowners either have no mortgages to add to their worries or are meeting their mortgage payments on time.

More important, some observers believe that "it is very likely that April 2008 will mark the bottom of the housing market." Cyril Moulle-Berteaux, managing partner of the Traxis Partners LP, a New York-based hedge fund, argues that three things have combined to make him optimistic: house prices have fallen, incomes have continued to rise, and mortgage rates have come down. These three trends have once again made houses, put out of reach of ordinary buyers by the price bubble of the 1990s and early 2000s, affordable again. So look to housing to "lead us out... of the credit crisis.

Still, the housing industry remains a drag on the economy, which is the "it" on which economists focus. And it is not the only one. High oil prices are siphoning off consumer buying power and devastating car sales, corporate bankruptcy filings are up 50% over last year's level, and ... well, you've been treated to so much bad news from a generally gloomy press that it needs no repeating here.

Less prominently displayed is the fact that exports are up, the unemployment rate remains low, job losses are diminishing, non-financial corporations are once again issuing

bonds to fund investment, and earnings of non-financial companies were up more than 10% in the first quarter.

Whatever happened to the depression we were promised, asks Gerard Baker, the (London) Times astute observer of the American scene. It still might hit us, and “caution seems to be the watchword....[But] even if the U.S. has a recession this year, the chances that it will turn into a full-blown slump are not high. ... Not so much [John Steinbeck’s] *Grapes of Wrath* as *Raisins of Mild Inconvenience*.”

So there is the usual disagreement among those for whom the “it” to be watched is the economy. We will either have a severe recession, or a mild one, or none at all. Best bet: hold your fire until we see how consumers react to the stimulus checks that are hitting mailboxes as you read this, whether gasoline prices have peaked, and whether the rest of the world continues to buy increasing amounts of made-in-the-USA goods and services.

Neither the “it” that money men look at -- credit markets; nor the “it” that economists look at -- jobs markets and economic activity; are the “it” that has politicians excited. To them, the economic circumstances of the nation are an opportunity -- an opportunity to posture, to regulate, to spend and, in some cases, actually to do some good.

Posturing seems the preferred route for too many. Hillary Clinton and John McCain want to suspend collection of the 18-cent federal gasoline tax -- a nonsensical proposal that would increase consumption of gasoline, which in a previous incarnation they sought to reduce by raising fuel-efficiency standards. Barack Obama lays out

economic ills at the feet of shady mortgage brokers who lured the unsuspecting and the untutored into buying houses they cannot afford, greedy oil companies, and the under-taxed rich. The lure of four years in the White House does bad things to candidates’ IQs and moral compasses. And to some of their colleagues. House Speaker Nancy Pelosi promises to attack the shortage of crude oil by raising taxes on the oil companies who use their funds to explore for new supplies, and by continuing restrictions on domestic exploration.

These politicians have a stake in continued economic turmoil. More serious politicians, from the Democrats’ liberal Barney Frank to conservative Republican Senator Richard Shelby, are trying to figure out how to balance the need to stave off excessive foreclosures, with all of the social costs that go with them, against the need to avoid “moral hazard” by bailing-out the greedy. Others are wrestling with the need to more closely regulate investment banks that since the Bear Stearns bail-out have guaranteed access to taxpayers’ funds, without stifling the innovations and creativity that have made credit more widely available.

There you have “it”. If “it” is the credit market, it is getting better. If “it” is the economy, we seem to have avoided a major recession, although it is too early to declare victory. If “it” is the political reaction to the aforementioned, all we can say is that we are seeing the usual mix of pandering and serious policy-making, with emphasis on the former from presidential wannabes.

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