

# The Credit Crisis of 2008

*As was the case a century ago, it's good to have a J.P. Morgan when you need one.*

BY IRWIN M. STELZER

**T**he really bad news about the debt crisis is that it is sowing the seeds from which will bloom, if that is the right word, hundreds of doctoral dissertations five or so years hence. Economic model builders, unchastened by the fact that their predecessors' models failed to anticipate, indeed, contributed to the great crisis of 2008, will concoct elaborate equations designed to reveal whether it was the Fed's interest rate cuts, or its pumping of hundreds of billions into the credit markets, or the JPMorgan Chase-led takeover of Bear Stearns, or Hank Paulson doing whatever it is Treasury secretaries do in these circumstances, or the calming words of George W. Bush that brought the credit crunch to an end.

Given the political bent of most university economic departments, it is a safe bet that President Bush will be found to be on the cause-side of the balance sheet, not the cure-side. So, too, will former Fed chairman Alan Greenspan, whose fondness for free markets will prompt the academics to blame much of the problem of 2007-2008 on his 18-year tenure as manager-in-chief of U.S. monetary policy. Other than those certainties, we can expect an inconclusive duel to the death of bored audiences by competing econometric models.

Not that we have not already learned a great deal about crisis containment. For one thing, it is good to have a

J.P. Morgan around. Students of history will remember that almost exactly 100 years ago, in 1907 to be exact, one J.P. Morgan rode to the rescue of a financial system on the verge of collapse—if one can imagine someone with the girth of the great 70-year-old banker riding to anything. It seems that the Knickerbocker Trust Company had backed speculators seeking to corner the market in shares of a copper company. They failed and so did the bank. Stuck

with unmarketable securities it had accepted as collateral (cf. today's subprime mortgages and other securitized paper), it had insufficient cash to meet depositors' demands. Other banks grew nervous, refused to clear with Knickerbocker, and tightened credit to the point where credit-worthy borrowers such as New York City, Boston, and Westinghouse could not sell their IOUs.

Enter J.P. Morgan. He cobbled together a consortium including John D. Rockefeller and other elite members of the rich-and-famous club to put up tens of millions, the Treasury added \$25 million of taxpayer money (a half billion in today's dollars), and trust-busting President Theodore

Roosevelt told his attorney general, "I felt it no public duty of mine to interpose any objection" to the complicated rescue scheme.

The rescue took about two weeks. Bernanke and the current head of JPMorgan Chase, Jamie Dimon, managed a similar feat in two days. Bear Stearns is no more. In a mere 100 hours, shares in the 75-year-old investment bank, trading, and brokerage firm fell from \$70 to \$2, the price at which it was picked up by Morgan. Factor in the \$1.2 billion at which Bear Stearns's Midtown Manhattan headquarters office building is valued, and Dimon got Bear for

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nothing. In this drama, Dimon played old J.P., and Hank Paulson played George Cortelyou, Roosevelt's Treasury secretary. Bernanke came on stage to show that Woodrow Wilson's decision to establish the Fed half a decade later was a good idea.

Which tells us something more about what future researchers will find: The era of free-market, no-government-intervention purists is over, if indeed it ever existed. Bush and Paulson have been leading the "no bailout" contingent, at least when it comes to poor, overextended homeowners trying to cope with suddenly higher payments as the teaser rates on their mortgages are reset. But to clear the way for Dimon to swallow Bear, the president and the Treasury secretary agreed to have the taxpayers guarantee \$30 billion of Bear's difficult-to-value assets. That puts taxpayers at risk; the precise nature of Bear's assets and liabilities is unknown to the Fed, which had no time to do anything resembling due diligence if it was to complete the deal before Asian markets opened on Monday morning. If the assets prove dicey, taxpayers will have to cover the loss. The risk-takers are us. Paulson might insist that he allowed the government to take on billions in risk only to save the system, rather than any one company, but if it looks like a bailout, and smells like a bailout, it probably is a bailout, certainly of the Bear Stearns bondholders, although employees, many of whom have been partly paid in shares in recent years, will prefer the term "wipe-out."

Paulson now finds that the intervention game he has learned to play might be more than the one-inning affair he had hoped. In for a penny, in for a pound, as British bankers say—although lately they have been willing to be in for neither. Democrats believe that government should insure mortgages that have been written down to current value (Barney Frank), send money to the states for the relief of homeowners facing foreclosure (Hillary Clinton), or provide those homeowners with help of a vague and unspecified sort (Barack Obama). Now that the Fed has decided that investment banks and brokers are too intimately interconnected with all the other players in the financial system to be allowed to fail—to the traditional "too big to fail" add "too interconnected to fail"—the taxpayer has become a key player. Not a new role: After all, the savings and loan crisis of the 1980s and 1990s came to

an end only when the government tossed about \$125 billion of taxpayer money at the problem.

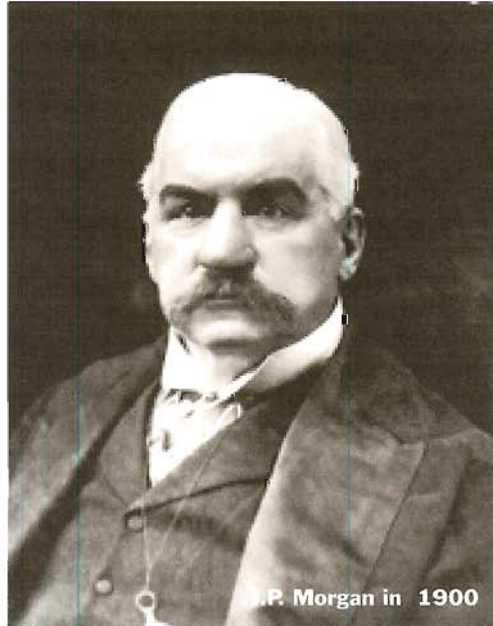
Future researchers are also going to have to sort out the relationship between the Fed's monetary policy, the rate of inflation, the value of the dollar, the trade balance, and a host of other economic drivers. The March 18 cut in the so-called Fed funds rate, lowering it to 2.25 percent (a negative interest rate, when inflation is factored in) was only the latest in a three-percentage point cut since September of last year. As every economist knows, or thought he did, such a reduction in short-term rates will bring

long-term rates, set in the market, down with them. Except that long-term rates, which are most relevant to businesses seeking to expand and consumers considering purchasing a car or a house, remain stubbornly high, diluting the stimulating effect of the Fed's actions. Many lenders believe that the Fed is playing too fast and loose with the money supply, and that the resultant inflation will drive down the value of the dollars with which they will be repaid. So they raise the price of their money—the interest rate that they charge for its use.

It seems that the inflation-wary have guessed right: Prices of food, energy, and just about everything that is not an electronic gadget have risen, and with them infla-

tionary expectations. All exacerbated by the path of the dollar, which has been spiraling down. Despite singing that old tune, "American interests are served by a strong dollar," the administration is humming under its breath something like "down and down it goes, in a spin, and we are loving the spin it's in." A cheap dollar makes our goods less expensive abroad, stimulating exports and thus adding significant growth to a slowing economy. True, the decline in the value of the dollars that oil producers are getting for their crude causes them to raise the price in order to protect their ability to purchase arms and baubles in the world's poshest shops. They also worry that the imported laborers who do the work that their native populations find offensive are restive: The dollars these workers send home to their families are buying less and less. The last thing the rulers of Arab nations want is an uprising by foreign workers who in many cases outnumber the native population.

True, too, that the falling dollar has the Chinese very nervous. "What concerns me now is the continuous depre-



J.P. Morgan in 1900

ciation of the dollar,” says Prime Minister Wen Jiabao. No wonder. The vaults of his country’s central bank are overflowing with stacks of financially deteriorating green paper adorned with pictures of American presidents. But Bernanke has had to choose: shore up the financial system by pumping dollars into it in such amounts that the banks will start lending again or fight inflation by keeping interest rates high. It’s an increasingly tough call, as the dissent by 2 of the 12 members of the Fed’s monetary policy committee to the last rate cut demonstrates. Bernanke is betting that the economic slowdown will lower inflationary pressures, and that if he has uncorked the inflation genie he will be able to bottle it up again by raising interest rates once the current credit crisis has run its course.

All of this is being played out against a background of longer-term problems in the banking system. As more and more loans are being written off, the asset sides of banks’ balance sheets are dropping. That reduces the banks’ ability to take on liabilities, i.e., to make loans. And by a large multiple since banks typically lend many multiples of their assets, and for long periods. That’s why runs on a bank can happen: If depositors or institutions that have lent the banks money on the basis of being able to get it back on demand decide *en masse* to show up at the teller’s window with withdrawal slips in hand (it’s done rather differently now, but many readers might find this description more comprehensible), there isn’t enough cash on hand to satisfy the demand for it. Which is what happened in 1907, and why J.P. Morgan was forced to round up a group of men willing to put up their own money to prevent a run—some contributing “under penalty . . . of lacking assistance when the pinch should come home to them,” as Carl Hovey put it in his 1911 biography of Morgan. I mention this only because when Long Term Capital Management went under in 1998, and Alan Greenspan organized a rescue effort by major banks in order to ease strains on the financial system, only Bear Stearns refused to help. Which might explain why the firm, famous for its macho, cigar-chomping, go-it-alone style found itself friendless just when it needed more than a few friends.

Two things have to happen before we put paid to the current problems. First, house prices have to bottom out.

So long as they keep falling, which almost all experts expect them to do, the value of the mortgages held by the banks will fall. In the case of defaults, the banks are lucky to get half of the face value of the mortgage. And when a house is worth less than the mortgage, the circumstance in which an estimated 8 million homeowners now find themselves, and 14 million soon might, we get the phenomenon known as “jingle mail.” That’s the term used to describe the sound when the owners walk away from their house and mail the keys to whoever is responsible for collecting their monthly payments of interest and principal.

Second, banks will have to raise more capital. Paulson wants them to stop paying dividends and retain those funds as new capital. This, the boards of most banks do not want to do, lest shareholders, many now holding onto their shares because dividends seem so generous, rise up in indignation. (Citigroup, which 10 years ago fired Dimon, has to maintain a dividend yield of over 6 percent to get anyone to hold its shares.) Bank presidents are making pilgrimages to the Middle East to meet with managers of sovereign wealth funds, which are attractive sources of capital from the point of view of bank executives for two reasons. These funds—the surplus revenues of oil-rich governments—are in

for the long haul, and they are passive investors rather than the sort who complain when bank executives mess up.

But once burned, twice shy. Sovereign wealth funds have watched the value of their investments in American banks wither under the dual blows of falling share prices and a declining dollar. At one time these foreigners were seen as a source of “dumb money,” which they earned merely by watching oil flow from the ground. No longer: They have taken on professional managers, and are also reserving a bit more of their wealth for internal development, as a glance at the skylines of many Middle Eastern cities makes abundantly clear.

How the banks will solve their need for capital no one can predict. My own guess is that we will see a combination of dividend cuts, the emergence of “bottom fishers” (investors who at some point decide bank shares are under-valued), and a call on taxpayers to swallow hard and ante up to rescue the banking system, even if that means also coming to the aid of bleating bankers. You know, the guys who were so generous to you when you came around for help without so much collateral that you didn’t really need any help at all. ♦

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