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ECONOMIC NEWS UPDATE

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Wall Street Welcomes the Fed

The financial world changed last week, and no one noticed. No one, that is, except policymakers in the Bush administration and the congress, and the free-wheeling investment bankers whose favorite pastime once was trumpeting the virtues of red-in-tooth-and-claw capitalism. On Thursday staffers from the Federal Reserve Board descended on Goldman Sachs, Morgan Stanley, Merrill Lynch and Lehman Brothers to check into their liquidity and solvency -- who they are lending to, who they are trading with, how much capital they have or can get quickly. It seems that all of the major investment banks, with the possible but not certain exception of Merrill (it won't say), have availed themselves of the Fed's new open-handedness.

Until now, and thanks to deregulatory measures passed by congress in 1999 at the urging of John McCain's top economic adviser, then-Texas senator Phil Gramm, no such supervision was deemed necessary. Gramm, made a vice chairman of UBS Warburg to "advise clients on corporate finance issues and strategy", remains

unembarrassed by his legislative record or the fact that his bank has had to write off \$38 billion in bad debts and cashier its Chairman, Marcel Ospel.

Whether because of or, as Gramm argues, in spite of his legislation that freed investment banks from many constraints, Bear Stearns is or soon will be no more, taken over by J.P. Morgan. But only after the Fed, backed by taxpayer money, accepted the risk of \$29 billion in loans on Bears' books in exchange for cold, hard cash. More important, Federal Reserve Board chairman Ben Bernanke has agreed to be the cashier of last resort for other investment banks, and says "We want to be sure that any lending we do to the investment banks will be done on an appropriately sound basis." That's a revival of a role the Fed abandoned in the 1990s, but that even Treasury Secretary Hank Paulson agrees is necessary so long as the investment banks can tap taxpayer funds.

More changes are in store. Americans bedeviled by more debt than some can handle are about to receive a lifesaver. Its exact contours are unclear,

in part because congress is not exactly certain how to balance the need to relieve homeowners' suffering against the danger of rewarding imprudent lending and borrowing. Nor is it sensitive to the law of unintended consequences. Remember, it is congress that passed the Community Reinvestment Act requiring the Fed to force banks to increase lending to poor ghetto-dwellers ("under-served communities" in the language of the Act) who wanted to buy homes. Enter the subprime mortgage problem. The very one that congressmen now blame on Alan Greenspan's interest rate policy, or Bernanke's failure to audit these banks properly, or investment bankers greedy for year-end megabonuses, or fraud-prone mortgage brokers, or all of the above.

Now we are to have Christmas in April, or at the latest in May. Democrats and Republicans returned to Washington after a two-week recess in which they were exposed to the complaints of constituents, and agreed that something must be done for overstretched homeowners. That usually results in legislation that resembles a Christmas tree -- something for everyone.

Senate Democrats got some of what they want: \$100 million to provide counseling to at-risk home owners, and \$4 billion in grants to communities to buy and refurbish foreclosed properties. Republicans' gift list includes home builders, who will get \$6 billion in tax breaks. In an attempt to put a stop to declining house prices, the Senate would authorize states to issue \$10 billion of bonds backed by mortgage revenues to fund the refinancing of existing homes and purchases by first-time home buyers, and various

government agencies to increase their backing for a variety of mortgages. Throw in a \$15,000 tax credit for anyone buying a residence facing foreclosure, and you have a Merry April for lots of people. Not Merry enough for Democrat Chris Dodd: he plans to add to the list more direct aid for homeowners falling behind in their mortgage payments.

But unless congress and the administration find a way to put a floor under house prices, and perhaps even then, the cure is not going to be concocted in Washington. It will come in part from the nationalization of debt implicit in the Bear Stearns bail out. Since investment banks will no longer be allowed to fail, they are finding it possible to raise capital, as Lehman did, and -- this lifted spirits -- as Merrill says it has no need to do.

Contributing to the restoration of confidence will be the deleveraging of the investment banking industry as the Fed's auditors gradually prohibit the inverted pyramid on which Bear Stearns was built -- \$34 of debt piled onto every \$1 of capital. It will come in greater part from the feeling that is taking hold that the huge UBS write-down, followed by the rise in the price of its shares, will finally encourage other banks to come clean, and get their balance sheets more in line with reality, raising more capital if necessary. Confidence will be restored when everyone feels the last Gucci loafer has dropped.

So much for the financial sector. The so-called real economy remains in or so close to recession that Bernanke finally used the R word. The economy has lost 252,000 non-farm jobs since the beginning of the year, and the unemployment rate has risen from 4.9% to 5.1%. Americans, spooked by \$3-\$4

per gallon gasoline, are leaving SUVs and small trucks on the car lots, driving passenger vehicle sales down to their lowest level in a decade. The manufacturing sector is slowing; consumers are more cautious; oil and food prices are painfully high. All true.

But consider Bernanke's entire comment, "A recession is possible. We're slightly growing at the moment, but ... there's a chance that for the first half as a whole there might be a slight contraction." Hardly a forecast of the end of the economic world as we know it. The manufacturing sector is shrinking, but only slightly. "We're moving sideways rather than into a major manufacturing downturn," says Norbert Ore, of the Institute of Supply Management. And consumers, who account for 70% of the economy, might not be increasing their spending, but neither are they cutting back. That might come, but so might a boost from the stimulus checks that will be in the mail in about 60 days, and the delayed effect of the Fed's interest rate cuts. Be worried, but not very.

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