washingtonpost.com

Look Out. This Crunch Is Serious.

Advertisement

By Edward Chancellor
Sunday, August 19, 2007; B01

Incipient panic has reigned in U.S. financial markets over the past couple of weeks, and no wonder. Some hedge funds have blown up, the country's second-largest mortgage lender has come close to collapse and stocks have fallen. On Friday, the Federal Reserve Bank lowered a key interest rate to help calm things down.

Yet most economists insist that Main Street will trundle along just fine, regardless of what happens on Wall Street. But will it?

It's true that some panics pass without consequence. But there are times -- think October 1929 -- when the tremors on Wall Street anticipate a more widespread economic storm. Given the tremendous run-up of debt in recent years, there's a good chance that today's credit crunch will turn out to be more than just a wisp of cloud in an otherwise blue sky.

Such wisps, to be sure, have appeared before. On Oct. 19, 1987, stocks fell by 22 percent. Nearly 60 brokerages went bankrupt, and many worried that a depression was around the corner. The fears were overblown. It turned out that the causes of the crash were merely technical. A large number of investors had been following a particular strategy, known as portfolio insurance, which required them to sell stocks automatically as the market fell. That created a cascade of forced selling. As the panic hit, the Federal Reserve Bank, with Alan Greenspan at the reins, rode to the rescue, providing money for the financial system. The stock market soon recovered.

The hedge fund Long-Term Capital Management started to collapse in the early fall of 1998. This fund, run by a bunch of the smartest traders on Wall Street aided by a pair of Nobel laureates, had borrowed about $25 for every dollar of its own capital. The market went haywire as LTCM's huge holdings in equities, bonds and other securities were sold. It turned out that many other investors had placed similar trades, also funded with borrowed money. Once again, the Federal Reserve performed its duty, providing liquidity to the financial system and even cutting interest rates. Over the next six months, technology stocks listed on the Nasdaq exchange soared by more than 50 percent.

The 1987 crash and the LTCM debacle each involved a "liquidity crisis." Forced sales of financial securities drove down prices, creating a panic and temporarily straining the capacity of the financial system. But liquidity crises per se have little if any economic significance. Provided the problem is contained relatively early on, a recession can be avoided.

Is that what will happen this time? In his 1873 book, "Lombard Street," British financial journalist Walter Bagehot described how fear spreads in financial circles: "Incipient panic starts with a 'vague conversation.' People are talked about every day, [and] as a panic grows, this floating suspicion becomes both more intense and more diffused: it attacks more persons, and attacks them all the more virulently than at first." At times such as these, Bagehot wrote, "men of experience" bolster their positions by borrowing money while it's still available. However, "minor money dealers come under suspicion" and have trouble finding funds.

That's a pretty good description of what has happened in the financial markets over the past month or so. In mid-June, a couple of hedge funds run by the brokerage house Bear Stearns announced surprise losses on investments in supposedly safe triple-A-rated mortgage securities. Over the following weeks, suspicions grew. Several other hedge funds, in the United States and abroad, have imploded. A small bank in Dusseldorf, Germany, that was supposedly funding mid-size industrial companies, has had to

be bailed out by German taxpayers after it announced large losses on liabilities kept off its books (shades of Enron). In Canada, a firm that helps companies issue commercial paper -- the stuff that goes into money market funds -- experienced problems rolling over its debts. People have suddenly realized that many money market funds were lending money to obscure investment vehicles that used their money to invest in subprime mortgage securities. Countrywide Financial, the second-largest provider of mortgages in the United States, has been forced to draw on emergency funding from other banks to stay afloat.

When fear replaced greed in the financial markets, Bagehot knew what the authorities should do. "A panic grows by what it feeds upon," he wrote. It "is a species of neuralgia, and according to the rules of science you must not starve it." Providing that the central bank lends freely at such times, the panic will pass. Over time, Bagehot's advice has become the orthodox practice of central bankers, whose main purpose is to act as "lender of the last resort." Both the Federal Reserve and the European Central Bank have dutifully performed this function over the past couple of weeks.

Treasury Secretary Henry M. Paulson Jr. believes that the recent flurry in the markets will have little lasting impact. A recent poll taken by Consensus Economics finds that most economists expect the United States to return to about 3 percent growth next year, which is around the average growth rate for the economy. But that's assuming that the recent credit crunch is merely a passing liquidity event, like the 1987 crash.

There are times, however, when credit booms have more profound consequences. Research suggests that severe financial crises tend to follow the rapid expansion of credit. The longer the credit boom endures, the more severe the hangover. Furthermore, because real estate is not liquid and the process of foreclosing on defaulted mortgage loans is time-consuming (as well as politically problematic), the economic downturns that follow property booms tend to be deeper and to last longer.

The experience of the U.S. economy after the 1920s and that of Japan in the 1990s appears to confirm these findings. In both instances, the period of credit expansion lasted several years, largely involved real estate speculation, and came to involve much of the population, whether that meant plunging into American stocks with borrowed money in 1929 or buying Tokyo condos with 100-year mortgages in the late 1980s.

Some economists take heart from the fact that inflation is currently quiescent. This ignores that the longest-lasting American crises over the past two centuries, those of 1837, 1873 and 1929, have each followed periods in which consumer prices were relatively stable. Needless to say, during the preceding booms, real estate and stock prices, fueled by rapid credit expansion, had soared.

The quality of lending and the "soundness" of credit also have a bearing on the extent of a crisis. Commenting on the collapse of the London bank of Overend, Gurney and Co. in 1866, Bagehot wrote that "losses were made in a manner so reckless and so foolish, that one would think a child who had lent money in the City of London would have lent it better." What would Bagehot have made of the so-called NINJA loans of recent years, supplied to homebuyers with "No Income, No Job and No Assets"? He may have raised an eyebrow at the "liar loans" given to those who falsified the information on their mortgage applications and would certainly have expressed disdain for the loans, many without traditional covenant protection for lenders, that until recently financed corporate buyouts.

Finally, a credit crunch is likely to have a bigger impact when the financial system has become weak. The so-called Long Depression that started in 1873 was sparked by the collapse of Jay Cooke and Co., one of the largest U.S. banks. More than 2,000 banks in the United States failed in 1931. Those failures wreaked havoc on the economy. Banking failures and bad debts plagued the Japanese financial system throughout the 1990s.

There's a good chance that the current panic will give way to a full-blown economic crisis. That's because the credit boom has been going on for five frenetic years and virtually everyone has become

involved, either directly or indirectly. An increasing number of businesses, from motorcycle retailers to cellphone operators, are finding their sales affected by the subprime debacle, according to the Web site Footnoted.org. Household spending continues to exceed income by a large margin. If credit stops flowing to consumers, the economy is bound to suffer.

Many people, including Treasury Secretary Paulson, believe that the financial system is robust enough to weather the crisis. It's true that, after many fat years, banks have lots of capital. But that was also the case in October 1929.

I believe that something profound has happened in recent weeks. The credit system is losing its, well, credibility. People no longer trust the triple-A ratings that many complex debt securities carry. The risk models used by rating agencies, hedge funds and banks have also come under suspicion. The effects of subprime losses are being felt in unexpected places, including supposedly impregnable money market funds. Hedge funds and other highly leveraged investment vehicles are being forced to unwind. After years of excess, credit is beginning to contract.

There has been a "run on Wall Street finance," said Doug Noland, editor of the online Credit Bubble Bulletin.

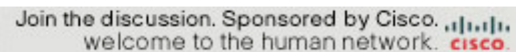
But no one knows how long it will last, or where it will end.

Edward.chancellor@ brea kingviews.com

Edward Chancellor is an editor with the financial commentary service Breakingviews.com and the author of "Devil Take the Hindmost: A History of Financial Speculation."

View all comments that have been posted about this article.

Post a Comment



View all comments that have been posted about this article.

Your washingtonpost.com User ID, dhaxton, will be displayed with your comment.

You must be logged in to leave a comment. Log in | Register

Submit

Comments that include profanity or personal attacks or other inappropriate comments or material will be removed from the site. Additionally, entries that are unsigned or contain "signatures" by someone other than the actual author will be removed. Finally, we will take steps to block users who violate any of our posting standards, terms of use or privacy policies or any other policies governing this site. Please review the full rules governing commentaries and discussions. You are fully responsible for the content that you post.

© 2007 The Washington Post Company

Ads by Google

Coffee Exposed
A shocking secret coffee co's don't want you to know
www.coffeefool.com

Veterans save 40%
Cremation or Funeral arrangements Serving Veterans Nationally
www.VeteransFuneralCare.com

All Military Records ®
Find any Military Record in 1 Min. Using The Database of Government!
Gov-Records.com