

Wake up to the dangers of a deepening crisis

By Lawrence Summers

Published: November 25 2007 18:51 | Last updated: November 25 2007 18:51

Three months ago it was reasonable to expect that the subprime credit crisis would be a financially significant event but not one that would threaten the overall pattern of economic growth. This is still a possible outcome but no longer the preponderant probability.

Even if necessary changes in policy are implemented, the odds now favour a US recession that slows growth significantly on a global basis. Without stronger policy responses than have been observed to date, moreover, there is the risk that the adverse impacts will be felt for the rest of this decade and beyond.

Several streams of data indicate how much more serious the situation is than was clear a few months ago. First, forward-looking indicators suggest that the housing sector may be in free-fall from what felt like the basement levels of a few months ago. Single family home construction may be down over the next year by as much as half from previous peak levels. There are forecasts implied by at least one property derivatives market indicating that nationwide house prices could fall from their previous peaks by as much as 25 per cent over the next several years.

We do not have comparable experiences on which to base predictions about what this will mean for the overall economy, but it is hard to believe declines of anything like this magnitude will not lead to a dramatic slowing in the consumer spending that has driven the economy in recent years.

Second, it is now clear that only a small part of the financial distress that must be worked through has yet been faced. On even the most optimistic estimates, the rate of foreclosure will more than double over the next year as rates reset on subprime mortgages and home values fall. Estimates vary, but there is nearly universal agreement that – if all assets were marked to market valuations – total losses in the American financial sector would be several times the \$50bn or so in write-downs that have already been announced by big financial institutions. These figures take no account of the likelihood that losses will spread to the credit card, auto and commercial property sectors. Nor do they recognise the large volume of financial instruments that depend for their high ratings on guarantees provided by credit insurers whose own health is now very much in doubt.

Third, the capacity of the financial system to provide credit in support of new investment on the scale necessary to maintain economic expansion is in increasing doubt. The extent of the flight to quality and its expected persistence was powerfully demonstrated last week when the yield on the two-year Treasury bond dropped below 3 per cent for the first time in years. Banks and other financial intermediaries will inevitably curtail new lending as they are hit by a perfect storm of declining capital due to mark-to-market losses, involuntary balance sheet expansion as various backstop facilities are called, and greatly reduced confidence in the creditworthiness of traditional borrowers as the economy turns downwards and asset prices fall.

Then there are the potentially adverse effects on confidence of a sharply falling dollar, rising energy costs, geopolitical uncertainties especially in the Middle East, or lower global growth as economic slowdown and a falling dollar cause the US no longer to fulfil its traditional role of importer of last resort.

In such an environment, economic policy needs to be governed by the clear and public recognition that restoring the normal functioning of the financial system and containing any damage its breakdown may do to the real economy is the central macro-economic and financial challenge facing the US. In the US today, as in many other countries in the past, confidence will return the first day an official statement about the economy proves to have been too pessimistic.

What concrete steps are necessary? First, maintaining demand must be the over-arching macro-economic priority. That means the Fed has to get ahead of the curve and recognise – as the market already has – that levels of the Fed Funds rate that were neutral when the financial system was working normally are quite contractionary today. As important as long-run deficit reduction is, fiscal policy needs to be on stand-by to provide immediate temporary stimulus through spending or tax benefits for low- and middle-income families if the situation worsens.

Second, policymakers need to articulate a clear strategy addressing the various pressures leading to contractions in credit. Very likely this will involve measures that are non-traditional, given how much of the problem lies outside bank balance sheets. The time for worrying about imprudent lending is past. The priority now has to be maintaining the flow of credit. The current main policy thrust – the so-called “super conduit”, in which banks co-operate to take on the assets of troubled investment vehicles – has never been publicly explained in any detail by the US Treasury. On the information available, the “super conduit” has worrying similarities with Japanese banking practices of the 1990s that aroused criticism from American authorities for their lack of transparency, suppression of genuine market pricing of bad credits, and inhibiting effect on new lending. Perhaps there is a strong case for it, but that case has yet to be made.

Third, there needs to be a comprehensive approach taken to maintaining demand in the housing market to the maximum extent possible. The government operating through the Federal Housing Administration, through [Fannie Mae](#) and [Freddie Mac](#), or through some kind of direct lending, needs to assure that there is a continuing flow of reasonably priced loans to credit worthy home purchasers. At the same time there need to be templates established for the restructuring of mortgages to homeowners who cannot afford their resets, so every case does not have to be managed individually.

All of this may not be enough to avert a recession. But it is much more than is under way right now.

The writer is the Charles W. Eliot professor at Harvard University