



The Current Financial/Economic Crisis: Causes and Thoughts

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Where Did it Start?

- Let's give credit where credit is due: the Boom/Bust of Subprime Mortgages and other high risk debt
- Housing Bubble and all that brought with it
- Cheap Easy Credit: No Doc, Option, Covenant Lite Loans
- But, Let's start with the Subprimes
- How and Why did they get out of hand?

SUBPRIME MORTGAGE ASSUMPTIONS

- Real estate prices tend to rise over time.
- Even very risky assets can be priced attractively.
- A diversified portfolio of high risk assets will have a lower risk than its individual components.
- Mortgages can be pooled (securitized) into more liquid investment vehicles.
- Leverage can be used to increase the expected return, especially when credit is cheap and available.
- But even reasonable assumptions can be taken to extremes

Subprime Mortgages: Seven Fools I

- First Fool: The **borrowers** who obligated themselves to mortgages that they could not service and often did not understand that the initial payment rates were teasers that would rise.
- Second Fool: The **mortgage originators** who believed that their risk models would allow them to profit even if many borrowers were unable to service their debts.
- Third Fool: The **securitizers** who assembled the mortgages into CDOs (Collateralized Debt Obligations) and sold them to investors with put back rights.
- Fourth Fool: The **hedge funds et al** who, believing that they could diversify away most of the risk, levered the high yields into the stratosphere.

Subprime Mortgages: Seven Fools II

- Fifth Fool: The **credit rating agencies** who believed the securitizers had assembled low risk CDOs out of high risk mortgages and that default rates could never go as high as they have gone.
- Sixth Fool: The **investors in commercial paper** who believed that the subprime loans backing up their paper were as solid as the credit agencies said they were.
- Seventh Fool: The **commercial banks** who extended back up lines of credit to the commercial paper issuers that they never expected to have to fund.
- Lesson: Never assume a greater fool will bail out your own foolishness.

The Subprime/Risky Debt Problem Extends its Reach

- Investment Banks
- Commercial Banks
- Hedge and Private Equity Funds
- Even Money Market Funds
- The Stock Market in General
- The Corporate Bond Market
- The Municipal Bond Market
- Insurance Companies
- Pension Funds
- University Endowments

The Real Economy is Impacted

Troubled Industries

- Financial Services
- Real Estate Construction
- Autos
- Airlines
- Consumer Durables
- Capital Goods
- Retailers
- Energy
- Eventually the Entire Economy

Spending Units are Impacted

- Consumers (down)
- State and Local Governments (down)
- Businesses (down)
- Foreign Sector (down)
- Federal Government (trying to offset)

Consumers Seek to Defend their Lifestyle

- Home Equity Loans
- Credit Cards
- 401Ks Raided
- Savings Depleted
- But these Sources have largely dried up
- Consumers have run out of Resources to fall back on
- They must deal with the New Reality of Limits

Consumers Face Tough Times

- Housing values on the decline
- Credit cards maxed out and providers cancelling and/or reducing maximum balances
- Only those with strong credit are now able to borrow
- 401K and other investment balances hit hard by market declines
- Layoffs and hiring freezes making for a difficult job market
- Raises for the Employed likely to be Modest/Minimal

Consumer Spending Declining

- Declining Income
- Declining Wealth
- Declining Access to Credit
- Declining Expectations
- Accordingly, Consumers are Reducing their Spending, especially for Big Ticket items

State and Local Governments Face Tough Times

- Consumer Income and Spending Down: Tax Impact
- Business Income Down: Tax Impact
- Real Estate Values Down: Tax Impact
- Financial Markets in Crisis: Borrowing Difficult and Costly
- Some Expenses are Rising: More need for Social Services Spending for the poor and near poor
- To Balance their Budgets, State and Local Governments must dramatically cut their spending

Foreign Sector

- US Economic Downturn Infects the rest of the World
- Financial Crisis leads to a “Flight to Quality”
- Treasury Bills, Notes and Bonds are Gold
- US Dollar Appreciates
- Our Exports are Hurt by the Weakening World Economy and the Rising Value for the Dollar
- Our International Competitors can now sell more Cheaply into our Economy
- Result: The Foreign Sector is an Increasing Drag on our economy

Businesses Face Tough Times

- Consumer Spending Declining
- State and Local Government Spending Declining
- Exports Declining Imports more Competitive
- Credit Expensive and Difficult to Access
- Equity Markets Depressed
- Venture Capital Hit Hard
- Overall Outlook: Gloomy
- So Businesses are Reducing Capital Expenditures and the Size of their Workforce

The Federal Government and Others

- Both Monetary and Fiscal Policy Attempting to offset the downward pressures on the Economy
- Fed has cut its target rate on federal funds deeply
- Fed/Treasury/FDIC have intervened heavily to thaw out the financial markets: adding equity, loans, guarantees, by one estimate over \$7 Trillion
- Large Increases in Government Spending Planned
- Other Countries Doing Likewise
- Is it Enough?

Problems Remain

- Audited Year end Statements: More Markdowns Coming
- Pension Funds: PBGC Exposure Huge
- Commercial Banks: FDIC Reserves?
- Underwater Housing: More Defaults Coming
- Insurance Company Reserves?
- College Endowments Hit Hard
- Derivatives :Transparency/Regulation
- Huge Increase in Government Debt
- Potential for Inflation Pressures

Outlook: Can we Muddle Through?

- Maybe/Perhaps
- Will the Markets Continue to like Treasury Securities?
- Will the Dollar Remain Strong?
- Obama Factor?
- Crude Oil Price?
- Wars and War Costs?
- Can and Will the US Government Put Enough into the Economy to fix things?
- Time will Tell