

Talking Points for  
DARDEN AND TUCK: “A NIGHT AT THE FED”

20 Feb 2008, Houston Branch of the Dallas Fed

First, I would like to thank the Houston-based alumni of Darden and Tuck for inviting me to this great gathering, A Night at the Fed. Special thanks to Michael Woodfolk for suggesting this to me and to Fred Stow and John Godbold for reaching out early on. Second, I must note that while in the past I was a Senior Economist at the Board of Governors in Washington and I am currently a Senior Fellow at the Dallas Fed’s Globalization and Monetary Policy Institute, I am in no way an employee of the Federal Reserve System and so my thoughts tonight should be seen for what they are...one Darden economics professor’s thoughts on some current issues.

I was asked to focus on uplifting topics like the probability that we are currently in a recession and the likelihood that the dollar will resume its downward descent, so I will begin with some thoughts on the current economic situation and on the dollar. So that I don’t finish this talk with a depressed audience, I’ll try to get the bad news out of the way early and then end on a more promising note.

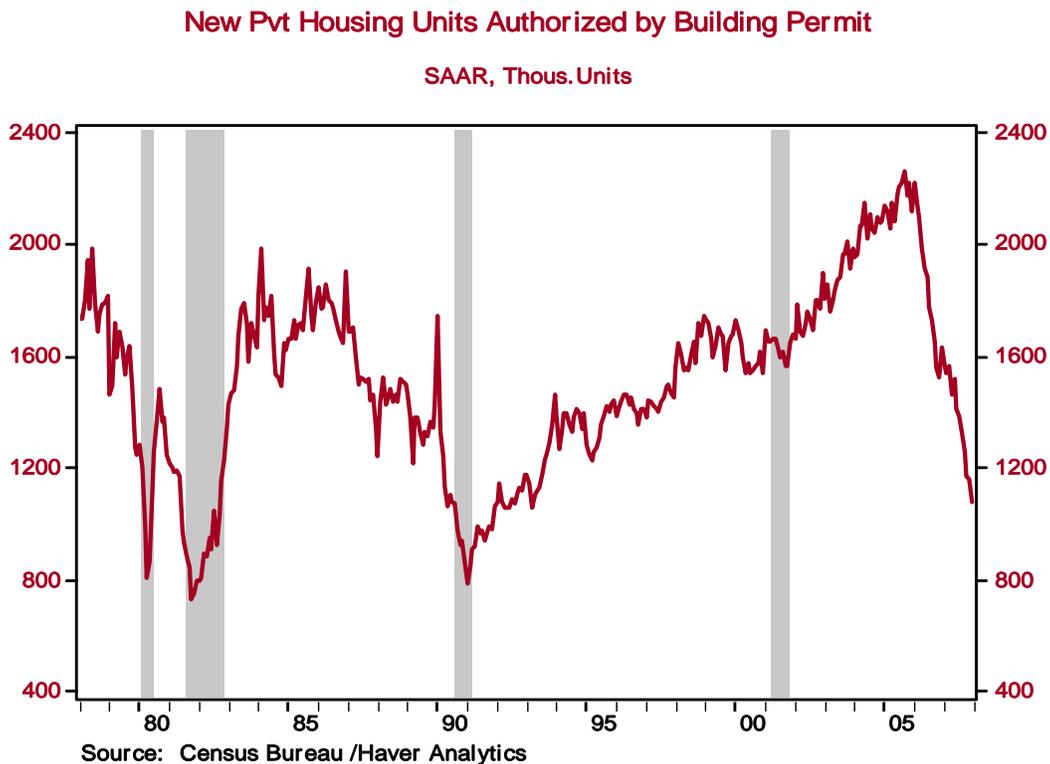
The current economic situation is, as I am sure we are all aware, pretty bleak. One potential real-time read on corporate prospects is the spread between high-yield corporate bonds and similarly dated Treasuries. That spread—depicted as the gap between the lines in the first chart—tends to spike leading into recessions, and has spiked recently, widening to about 700 basis points. This portends higher borrowing costs for many companies, but it could be that markets have it wrong...perhaps the widening is overdone and the spread will tighten in the coming weeks and months. Either way, a widening junk-to-Treasury spread is a warning signal that shouldn't be ignored.

**Chart 1: The Junk-to-Treasury Spread Is Widening Sharply**



A clearer signal comes from the housing market. New building permits—one of the so-called leading indicators of economic activity—have fallen off the table. A picture is sometimes worth billions (of dollars) of words, so glance for a second at Chart 2. Even in the best of times a slowdown in the housing sector of this magnitude would seriously impinge economic growth.

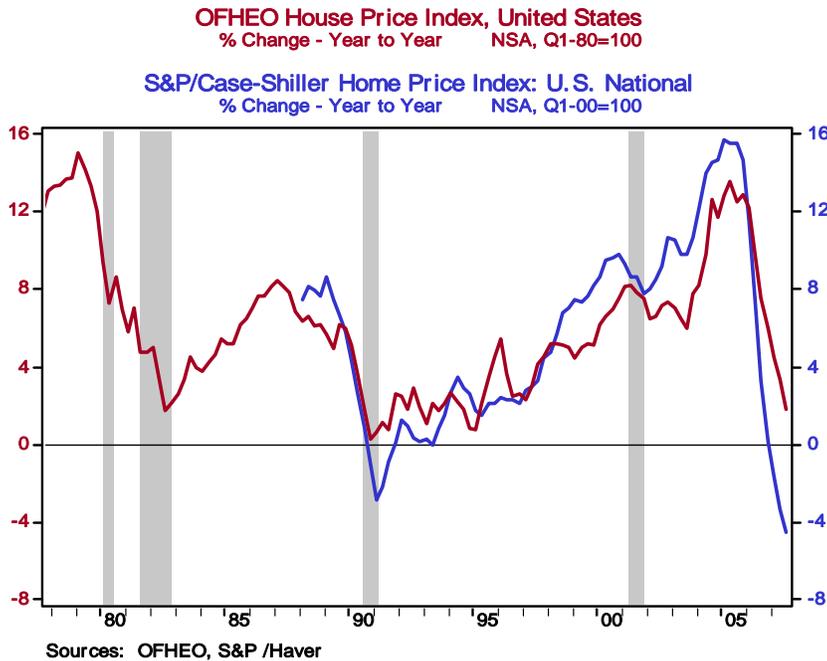
**Chart 2: Building Permits Falling Off the Table**



The prospective sharp decline in building has hit builders hard, and the sector will likely see many bankruptcies. Of course, we know why

homebuilders have seriously cut back plans to increase the stock of houses. Yes, there was evidence of an oversupply even prior to the current woes, an oversupply that would have taken some time for even a robust market to work through. But there is another factor: There are potentially thousands of existing homes that might be forced onto the market in coming months. This owes to the unhappy combination of lending standards that appear to have been predicated on the notion that asset prices are ever-increasing and, as it turns out, asset prices that are not ever-increasing. Falling asset prices—in this case, home prices—seem not to have been a possibility in some lenders thinking. We don't even have to get into LIAR loans or NINJA loans (no documentation of income, job, or assets)...with loan-to-value ratios at or near 100% for many recent home loans, any drop in home prices will leave a mass of people with negative equity and an incentive to join a new group in the U.S. economy, the 'mortgage walkers'. This, of course, would put a large chunk of the housing stock in hands of banks, who presumably would be motivated sellers, thereby putting downward pressure on home prices. Home prices that, as we know, seem to be falling quite nicely without the additional pressure (Chart 3).

**Chart 3: Home Prices Falling Like It's 1980 (or worse)**



There is no reason to single out the housing sector as the culprit of our current economic woes. Lax standards have been prevalent on both sides of deals in a wide and varied set of industries. Take the misnamed ‘monolines’. Originally in the usually staid business of insuring muni bonds, a 1998 change in regulations allowed them—through shell companies known as ‘transformers’—to delve into derivatives. Monolines exploited this regulatory change to the hilt, writing insurance on about \$100 billion of complex mortgage securities. Now they want to call a mulligan and separate

this now ‘bad book’ from their original, presumably better, presumably more boring muni book.

### **Innovation is Difficult, Mimicry and Gimmickry are Easy**

The monolines, as we now know, used the regulatory change to go full blown into collecting premiums on credit default policies. This strategy, which led to a phenomenal increase in their fees and stock prices, would be fine as long as asset prices *never* fell and defaults *never* rose. I don’t pretend to fully understand “sustainability” but I am pretty sure that a business strategy built on two “nevers” isn’t sustainable; some monolines stocks have recently been 90% off their highs, and by some estimates monolines will last in their current form for perhaps one more week.

In 2004, as a favor to a friend, I gave a keynote at the annual conference of the Anglo-American Real Property Institute, a group, as far as I could tell, of real estate investors. The main takeaway from my talk was—and I’m not sure that group needed me to tell them this—that the low real interest rates at the time would spur a movement in search of yield via riskier investments. Who knew the extent of that search for yield and where it would leave us.

The search for yield has affected a wide range of companies.

- Bristol-Myers Squibb, like many companies, held ‘auction-rate securities’ on its books as cash. Bristol-Myers was told these securities were as liquid as cash and, by the way, would earn them a few more basis points. Sounds great...until the securities don’t trade, become as liquid as a house, and prompt a \$275 million charge. It’s heartening to hear that they’ve learned their lesson (presumably not for the last time), as the CFO has recently asserted “We are a pharma company, not a financial company.”
- UBS got into trouble by straying from their core competencies and mimicking their competitors. Reading about their troubles, “everyone was doing it” seems to best summarize their thinking.
- Northern Rock supercharged their profits by relying on a strategy predicated on capital markets always functioning super smoothly. But markets, we’ve always known, occasionally seize up. Northern Rock’s fate: Nationalization by the British government.
- IKB, a small German bank, got into trouble by looking for an easy way around a business model that had become antiquated. What happens when you can no longer make money the way you originally did? You can innovate in a meaningful way, or you can find a gimmick. IKB’s gimmick was to grossly overstep their bounds by going headlong into

structured securities. The extra earnings kept them afloat until the market cracked, now the only thing keeping them in ‘business’, whatever their business might be, is repeated bailouts from the German government. And why would the German government bail out a small Länderbank with an outmoded business model? Because the huge and financially savvy KfW is said to likely become wobbly if IKB falters.

This list could go on and on. In retrospect it all looks like a pyramid scheme: a scheme that works just fine as long as asset prices continually increase and no one defaults.

All of this will clearly impact the U.S. economy in a substantial, negative way over the short- to medium-term. A slowdown in growth is a done deal. Whether we are currently in, or will soon be in, a recession is in my mind a moot point. Economic growth will clearly slow to such an extent that it won't keep up with population growth. Whether we cross zero or not in terms of real GDP growth isn't all that relevant; either way we'll have less output (or income) per person. That sounds like a recession to me.

## **What's the Government to Do?**

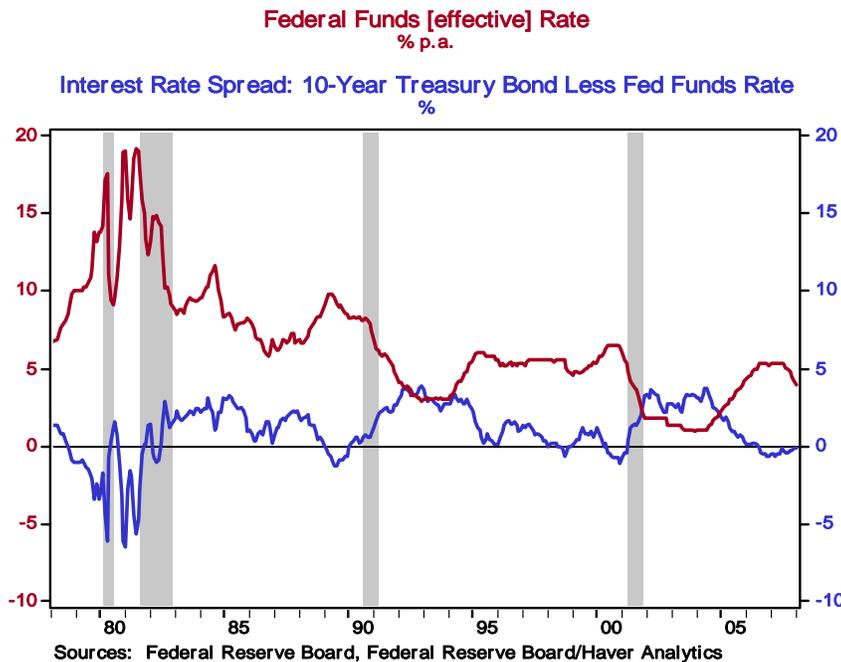
We always hope that solutions directly address the cause of a particular problem, not just its symptoms. This time I'm not sure our traditional policy tools are up to the task of addressing our current ailments.

Right now we seem to be in a credit crunch—an economy-wide deleveraging—caused by a lack of confidence caused in turn by opacity. No one knows where further bodies are hiding. No one knows how much further decreases in asset prices will spur more and more rounds of defaults, writedowns, and retrenchment. Right now it is difficult to imagine bank lending, curtailed first by having to bring SIVs onto the balance sheet and then again by huge writedowns on bad debt, recovering anytime soon. Caution will be driving decisions for a while. Credit standards will continue to be tightened. Credit will be scarce. A fundamental, long-term driver of growth—capital investment—will have funding difficulties over the near-term.

One potential indicator of when the end might be near will be asset prices. If they are dropping, rational people might sit back and wait. Retrenchment. When asset prices bottom out and start to solidify, normal activity should resume.

What can the government do to spark a turnaround? Not much, I'm afraid. The Fed has provided liquidity where it can and has aggressively lowered short rates, but ours isn't a problem of rates being too high. (Ex post) real 10-year rates are already at zero, a level they haven't been at since 1980. At the margin, an aggressive loosening of monetary policy, if it causes the now-flat yield curve to steepen (Chart 4), can help banks shore up their balance sheets by allowing them free money (as they can fund themselves short-term at very low rates, park the money in longer-dated assets and pocket the spread).

**Chart 4: Yield Curve Flat, Fed Loosening Aggressively**



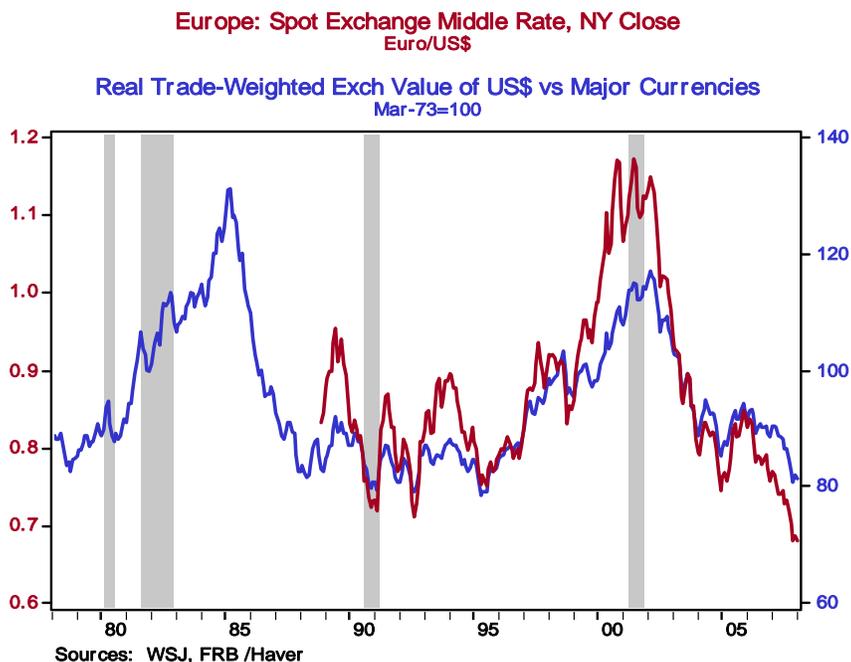
Similarly, current fiscal proposals—refunds, tax breaks, and the such—will not address the problem and thus cannot be expected to be of much help. Sure, there might be a boost to spending that will give a one-time kick to the economy, but a temporary demand boost like that cannot address the underlying problems in the economy.

The government can, and will, address holes in regulation that allowed human nature run amok to bring us to the brink of a systemic meltdown. That'll help for some time but, as we all know, over the span of history financial system booms and busts occur like clockwork every few decades. Fifteen years from now someone somewhere will, rather than innovate, take the easy way out and, when followed by friends and competitors, will bring the system close to the brink yet again. As the FT's Martin Wolf recently put it, "We have a banking sector that has a demonstrated capacity to generate huge crises because of incentives to take on under-appreciated risks...(and) we lack the will and even the capacity to regulate it." I suspect he's right on the former; I hope he's wrong on the latter.

## The Dollar

Enough gloom. On the dollar I am actually bullish. Yes, the dollar has fallen pretty spectacularly since the end of 2001 against the euro—a dollar used to get you about €1.15, now it fetches about €0.67. The dollar has also depreciated, in real terms, against the currencies our major trading partners, albeit not as sharply as against the euro (Chart 5). The sharp real depreciation could support economic activity in the U.S.—at a time when we really need it—as U.S. exporters find it easier to sell their now-inexpensive goods abroad, and you all switch from a Sicilian Nero to a Texan Cabernet.

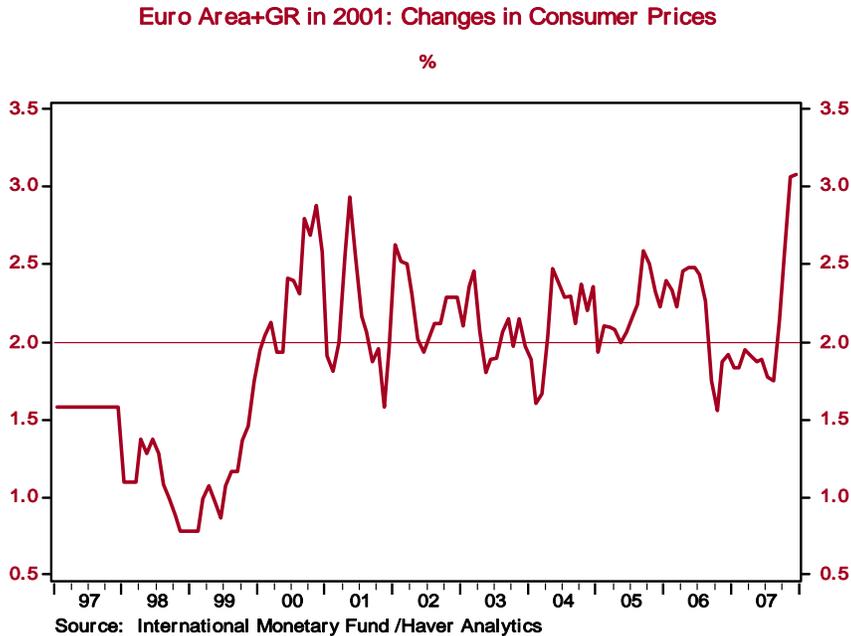
### Chart 5: The End of Another Long Wave?



Will the dollar continue to fall? Certainly, a case could be made for that to happen. But I don't think it will. I rest that call on two assumptions. One, I think interest rate differentials will no longer be so euro-supportive. Two, I'm not worried about the large U.S. current account deficit, as long as we remain a world-class place to invest.

On interest rate differentials, much is being made of the fact that the Fed is aggressively lowering short rates while the ECB is standing behind its inflation targeting policy of maintaining inflation below but near 2%. With inflation currently at a euro-area record high of over 3%, the assumption is that the ECB will certainly not loosen (which would likely cause more inflation). But if you look at ECB performance on inflation (Chart 6), they've almost never hit their inflation target of below but near 2%. And at times they've aggressively loosened monetary policy while inflation was above their target. My guess is that euro area growth will slow considerably. French consumer confidence is at a 20-year low, euro zone confidence is tumbling, the IMF expects euro area growth to slow more than U.S. growth. Once growth slows in Europe, if past behavior is any indicator of future behavior, the ECB will start to loosen its monetary policy, and this will provide support to the dollar.

## Chart 6: The ECB: What Inflation Target?



Another support for the dollar is our world class capital markets. If we maintain the quality of our markets—in part through wise, not lax, regulations—there is no place on earth that can rival us. Where else can large outsiders place their money and expect not to be ripped off? We've gotten into trouble in part because so much is now occurring outside the reach of regulation, and maybe that trend will continue, but for basic, powerful, plain vanilla capital markets it's tough to rival the US. (That said, a current proposal to *tunnel* good monoline assets into one company and create another company for the bad assets, leaving investors—mainly big

banks, I suspect—holding the bag smacks of the type of shenanigans that in many countries are lawful but clearly deter any outsiders from committing capital.)

And, as any student of economics knows, it isn't the size of a trade deficit that puts downward pressure on a currency, it's the size of that deficit relative to the amount of foreign capital that wants to flow into the economy. It is interesting to note that while the euro area is fast becoming a potential alternative to U.S. capital markets, it's the *euro area* corporate bond market that has seized up in recent months, not the U.S. market. In fact, the biggest and best in Europe have been issuing in U.S. capital markets as liquidity in Europe has dried up. Of course, if we, and others, have reason to lose faith in our capital markets, all bets are off (or on, but in the other direction).

### **What Does the Future Hold?**

The reason to be bullish on America over the long term has not changed. We have a vibrant capital market with a host of funding options: spare tires or a redundancy of funding options, as Chairman Greenspan would say. Some of the current options will surely disappear, but that doesn't mean that the financial innovation seen over the past decade was bad. Quite the contrary, the financial innovation over the past decade has

definitely been beneficial. Yes, the excesses of the past few years means that we'll give back some of those gains, but on net we've seen great progress over the past decade.

One can think of financial innovation as we've seen as a step from opacity to transparency and ultimately the formation of new asset classes. Take junk bonds. Scandalous twenty years ago when they were opaque and just run from Michael Milken's desk. They had their crisis, regrouped, became more transparent, and nowadays junk bonds are a legitimate asset class. Some of the current financial innovations won't likely have long lives—SIVs, for example—but some will and our financial system will be better for it.

More importantly, we still have a system that allows the best entrepreneurs and corporate strategists in the world to flourish. That was true a decade ago and continues to be true today. It's the people in this room, and a system that allows them to flourish, at times to fail, but always to get back on their feet and continue the hard work of innovating, not just replicating, but innovating, that allows one to be a long-term U.S. bull. U.S. corporations, at least the ones that don't drift too far from their core competencies (like getting too cute with financial products), are in great shape. And as one excellent young French economist (who happens to be at

NYU) put it, the U.S. has a high-powered innovation ecosystem that generates the Microsofts, Genentechs, and Googles of the world. But this isn't just a high-tech story: In the U.S. entrepreneurs and companies can get funding from a variety of sources. This source of economic growth—the depth and variety of our financial system—will last far beyond the current crisis.

So, yes, we're in for a rough time ahead. But at these levels I'm a dollar bull and, more importantly, the U.S. financial system—rather than being evil personified—will support real-sector innovation for years to come.

I will close by just saying thank you, once again, for inviting me to gather with you on this fine Houston evening.