Gales of Punitive Destruction

There is not enough room on page one of the nation’s newspapers for all of today’s news. Any of today’s stories—a Lehman bankruptcy, a sale of Merrill Lynch, AIG capital needs, plummeting oil prices, or new Fed lending facilities—could be above-the-fold headline news. The US is moving through its deepest set of financial market difficulties since the 1980s and 1990s, during the banking and S&L crisis.

The key thing to remember here is that the emphasis belongs on the word financial. These financial market problems are not a result of widespread economic weakness, otherwise known as a recession. In fact, real GDP has grown 2.2% in the past year and accelerated to a 3.3% annualized growth rate in the second quarter.

The economy is not taking down investment banks; lousy lending standards and the excessive use of leverage are taking down investment banks. And just like the problems of the 1980s and 1990s, the roots of the problem reach back to a period of absurdly low interest rates. When the Fed cut interest rates to 1% in 2003, balance sheet math involving leverage-based strategies turned so lucrative that many financial market players could not help themselves. Wall Street based its business model on leveraging up the most leveraged asset on Main Street – housing.

This double set of leverage has blown up because the housing market became overbuilt and housing prices stopped rising. When the Fed pushes interest rates below their “natural” level, mal-investment always occurs. Mark-to-market accounting exaggerated this process by letting firms mark-up assets above true fundamental value on the way up, but has now turned to force firms to mark-down assets, to below true fundamental economic value.

The good news is that this financial earthquake is unlikely to turn into an economic earthquake. The bad loans made earlier this decade did not create a widespread economic boom; and the realization of how bad some of these loans are will not create an economic bust. The non-housing economy, which is roughly 95% of total US economic activity, has been remarkably stable. In the three years ending March 2005, non-housing real GDP grew at a 2.7% annualized rate. In the three years since then, non-housing real GDP has grown at a 3.2% average annual rate.

This is not that hard to understand. Think about a bad loan made to a home buyer. Clearly that allows the borrower to spend more than they have earned. But every dollar of this cash comes from someone else, who has to spend less than they earn. Even when the money comes from abroad, that means fewer dollars available to buy our exports. Is it any wonder that the trade deficit was booming when capital was readily available for mortgage loans on easy terms and now the trade deficit is falling rapidly when mortgage credit has slowed?

Remember: lending and credit expansion, by itself, is not the equivalent of printing money; it simply shifts the pocket in which the money is located. Credit contractions come and go, but only credit contractions caused by government policy mistakes lead to widespread recession. This is why the current financial market problems are unlikely to spread.

There have been no major increases in tax rates, no sudden lurches into trade protectionism, and no prolonged period of tight monetary policy, where the federal funds rate is persistently above the trend in nominal GDP growth. In fact, tax rates are still relatively low and the Fed is holding interest rates at extremely accommodative levels.

It is difficult to gauge when financial market upheaval will finally come to an end. However, as long as policymakers steer clear of tax hikes, tight money, and protectionism, the economy should remain resilient.