The Message in the Financial Noise
Barry Eichengreen
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Recent turmoil in the market for U.S. mortgage-backed securities has provoked much anxiety and not a little schafenfreude. While it is tempting to join the legions of those claiming "I told you so," it is more constructive to inquire into the implications for the economy.

Many observers have sought refuge in the belief that turbulence will be limited to financial markets – that it will not negatively affect economic growth. But the Fed does not see things this way. Mr. Bernanke did not cut the discount rate last Friday because he wanted to bail out investors. To the contrary, he wished to avoid being accused of rescuing those who have taken highly-leveraged bets on risky assets. Both to fend off political criticism and to avoid encouraging future risk taking, he would much prefer that such investors suffer their comeuppance. But the Fed's first responsibility in a situation of serious downside risk is to prevent a recession. That Bernanke and Company were prepared to cut the discount rate and risk political criticism is a clear indication that they see the probability of recession as significant.

As they should. The market in mortgage-backed securities is falling because the U.S. housing market is falling. Existing home sales had dropped by 20% from their peak even before the most recent bout of financial turmoil. New home sales had declined by 40%. The inventory of unsold homes had already exploded. And once as many as 6 million homeowners, with teaser mortgages featuring interest rates that reset at higher levels after 2 years, default on their loans, there will be an additional inventory of foreclosed houses. Given that residential investment accounts for 40% of all fixed investment, it is no wonder that the Fed smells recession.

Home prices haven't moved, of course, because there have been no recent transactions. But a 20% fall in prices, once next winter's snows melt and the market comes out of hibernation, would be a very modest response to the deterioration in market sentiment.

As recently as last year American households were extracting upwards of $750 billion from their homes in the form of capital gains and refinancing. The American consumer, who has been using his house as a piggy bank, now has to tighten his belt. Last week's frightening fall in the consumer confidence index shows that he knows it. And as the American consumer retrenches, foreign firms that depend on the U.S. export market can kiss their profitability goodbye. This in turn explains why Asian markets responded so negatively.

Notice how I have told this story without mentioning collateralized debt obligations (CDOs), Alt A mortgages, and other financial arcania. I have done so in order to emphasize that origins of the problem are more than financial.

Of course, financial volatility and turbulence only make matters worse. As households default on their mortgages, specialized mortgage lenders go under. There is now even a website, *MLimplode.com* for "mortgage lenders implode dot com," tracking their number. As lenders fail, loans are harder to come by, and housing prices soften further. As home prices fall, the collateral in collateralized debt securities is worth less. Since mortgage originators can't sell them, they can't borrow the money that they customarily lend to prospective homebuyers. Investors then wake up one morning and discover that lax loan standards and inadequate income documentation were not limited to the subprime end of the market. They grow unsure about how serious this problem is in their quality tranche.

Of course, to claim no knowledge of these problems is disingenuous. So long as everyone else was buying CDOs, fund managers felt compelled to buy CDOs to match the competition. So long as housing prices were going up, no one bothered to seriously assess the value of collateral. As that renowned financial advisor, Captain Renault, said in *Casablanca*, "I am shocked, shocked, to find that gambling is going on in here."

Be that as it may, the result is that the prices of the senior (AAA) and mezzanine (AA to BB) tranches of CDOs are also falling. Holders find themselves strapped for cash. Originators and their financial partners find such securities impossible to issue. Even households with good credit are unable to borrow.

What is revealing is that the so-called smart money has not swooped in to buy up the distressed assets. The big investment banks and hedge funds remain on the sidelines. Distressed investors are forced to sell, but virtually no one is willing to buy. This is what is currently being called a "liquidity crisis." The market is illiquid – it is difficult to complete transactions at any price, in other words – because everyone wants to sell and no one wants to buy. Vulture funds specialize in scooping up distressed assets. They make money capitalizing on precisely this situation. Some of them have cash. That they refuse to use it indicates that they, like the Fed, realize that things will get much worse before they get better.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics and Political Science at the University of California, Berkeley.