

# US Financial Policy Challenges

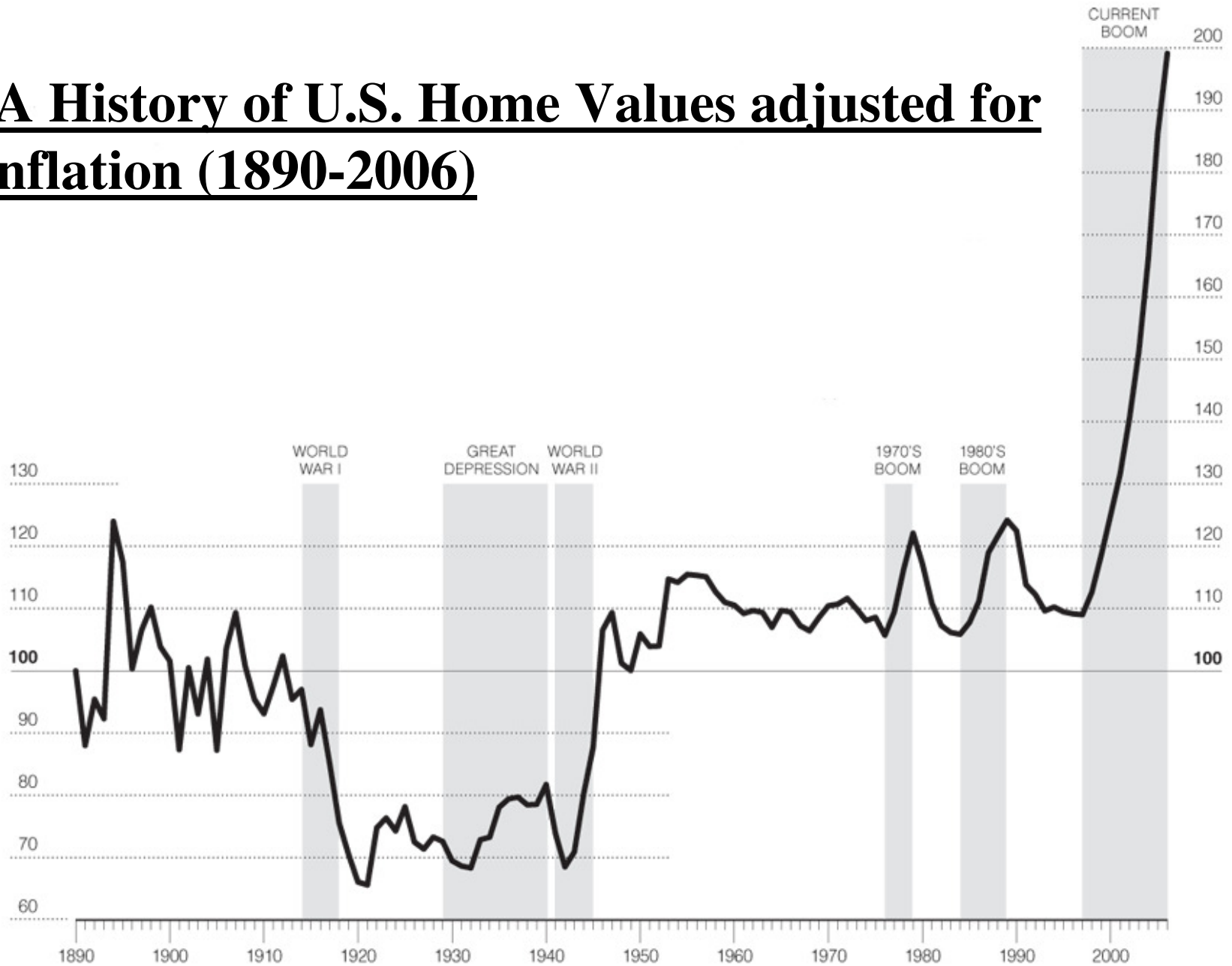
National Policy Forum  
November 30, 2007

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American Enterprise Institute

# **Constellation of Challenges for U.S. Financial Policy**

- Worst housing market bust over the past sixty years
- A more severe credit crunch than that of LTCM
- A major international oil price shock
- A faltering equity market
- The risk of a full blown dollar crisis

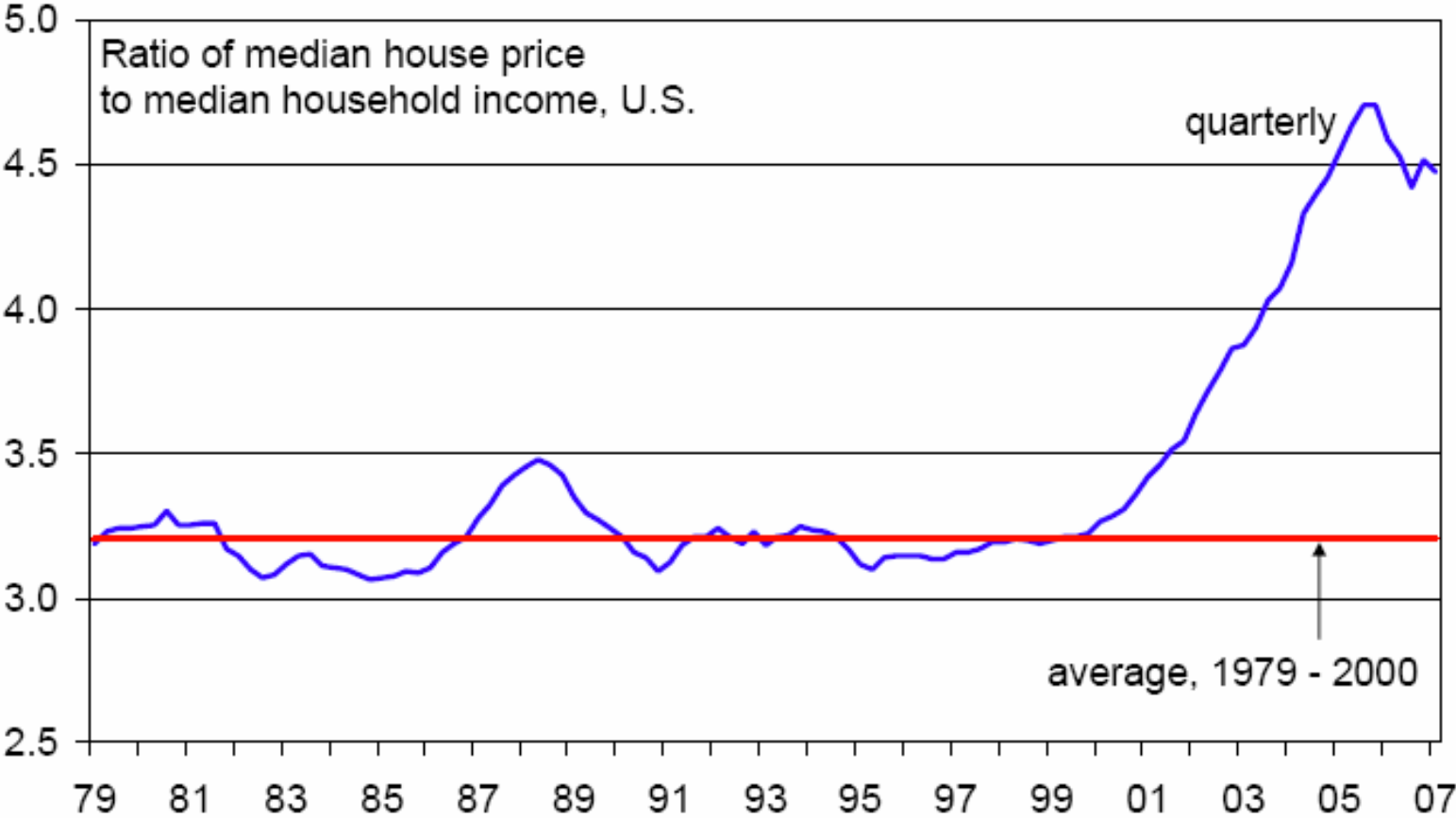
# A History of U.S. Home Values adjusted for inflation (1890-2006)

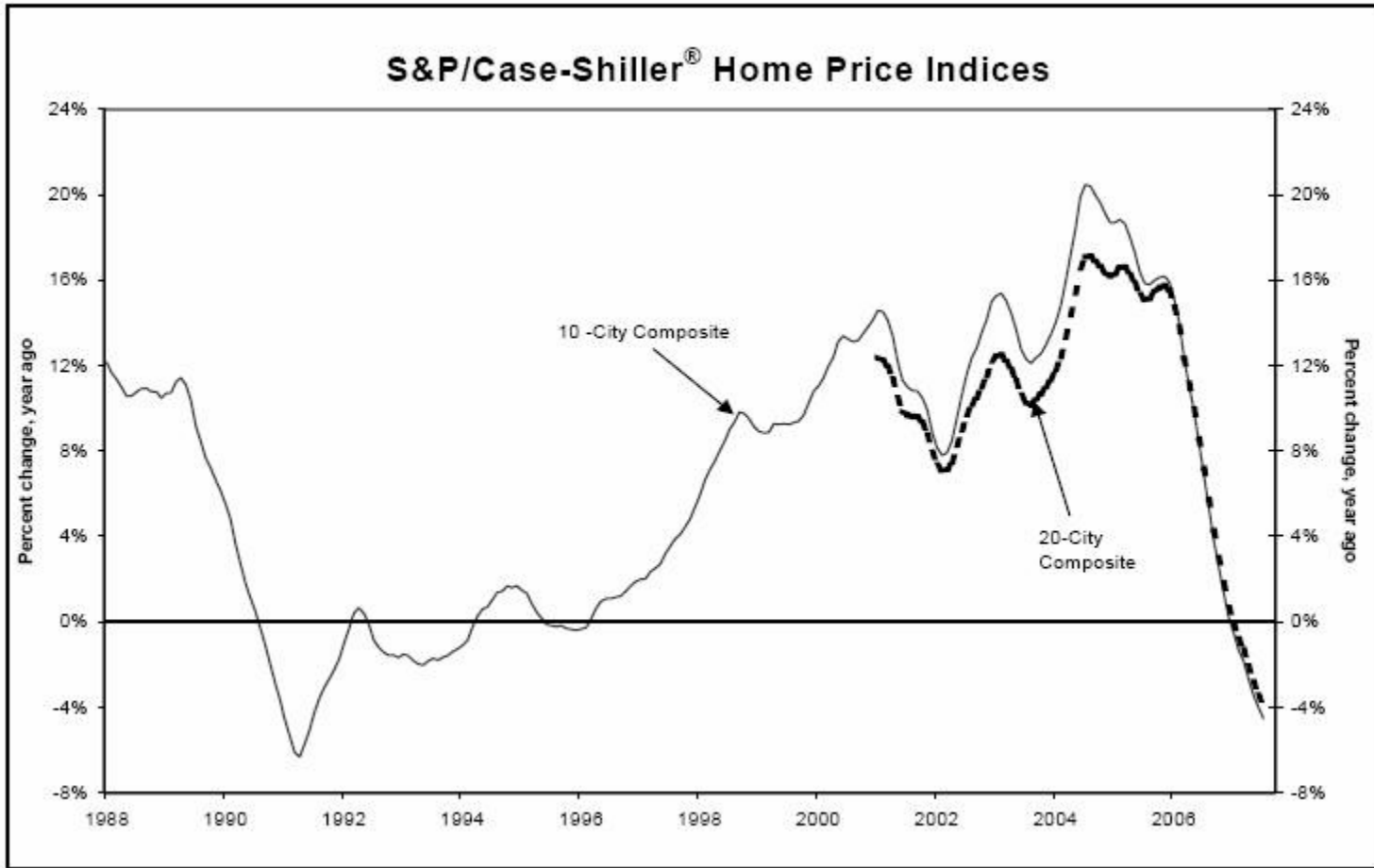


Source: "Irrational Exuberance," 2nd Edition, 2006, by Robert J. Shiller

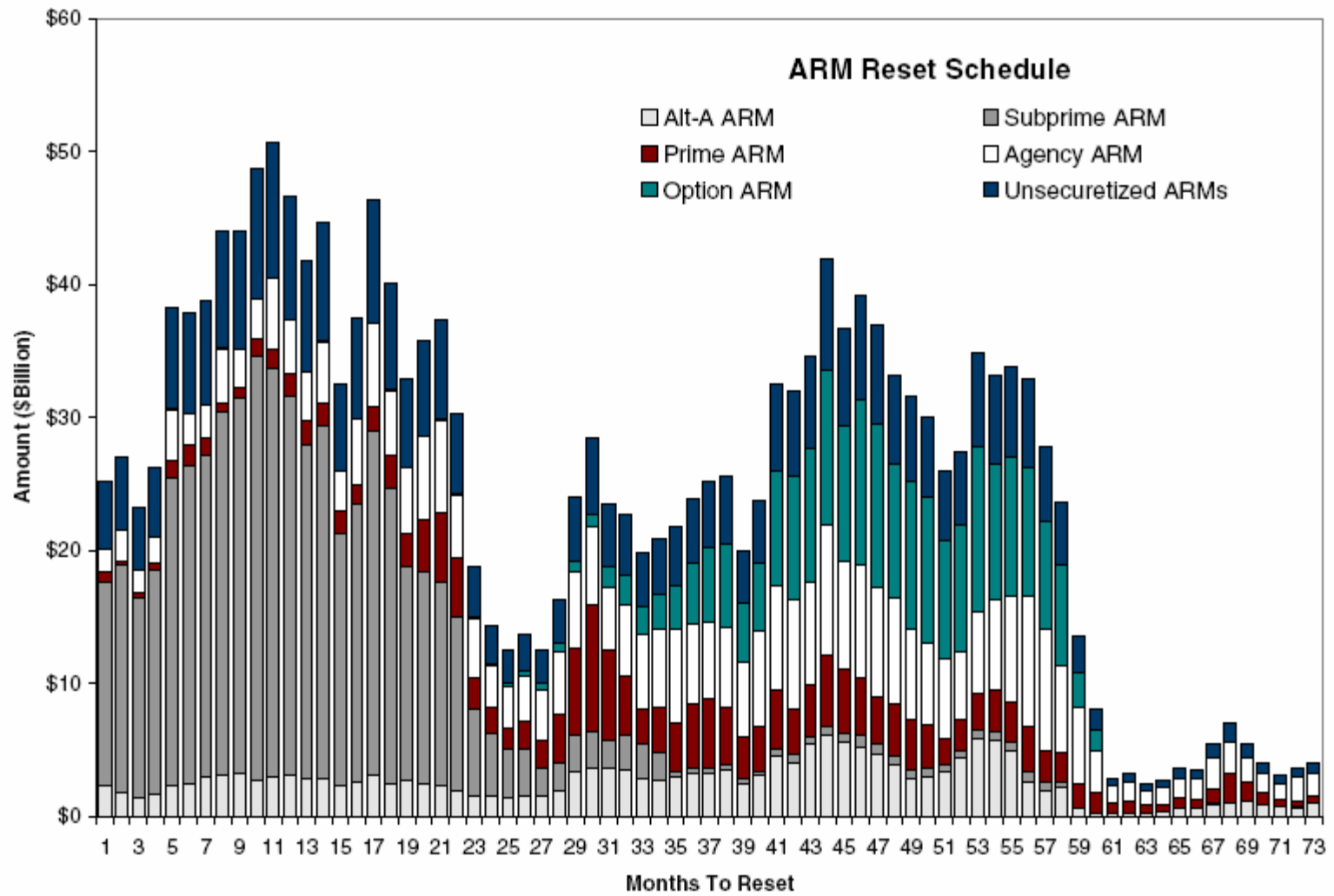
Bill Marsh/The New York Times

# Affordability Went Bust During The Housing Boom





## Adjustable Rate Mortgage Reset Schedule

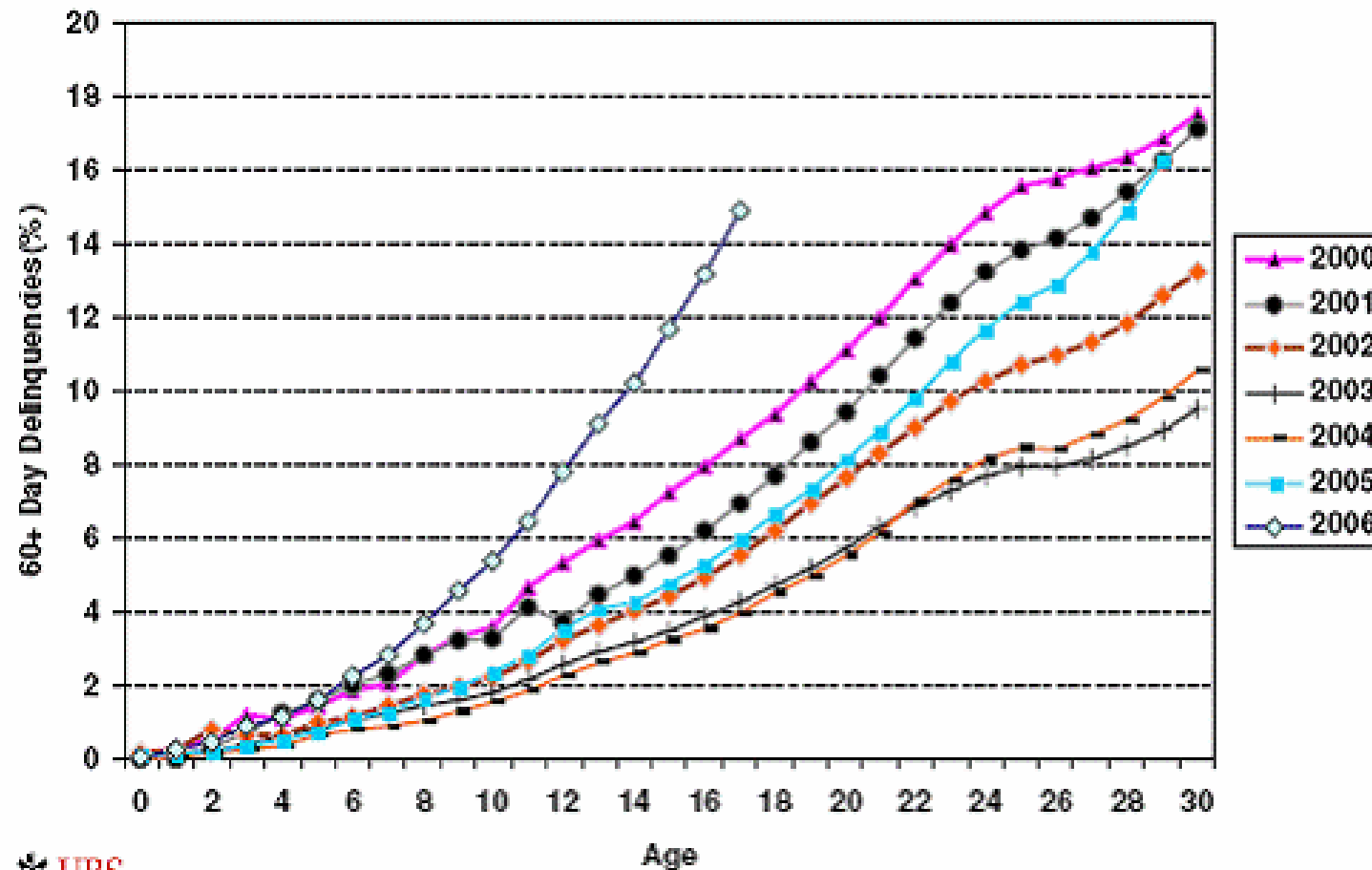


Note: Data as of January 2007.

Source: Credit Suisse Fixed Income U.S. Mortgage Strategy.

# Subprime 2006: The Worst Ever!

2006 Delinq= 2 x Historical Norm

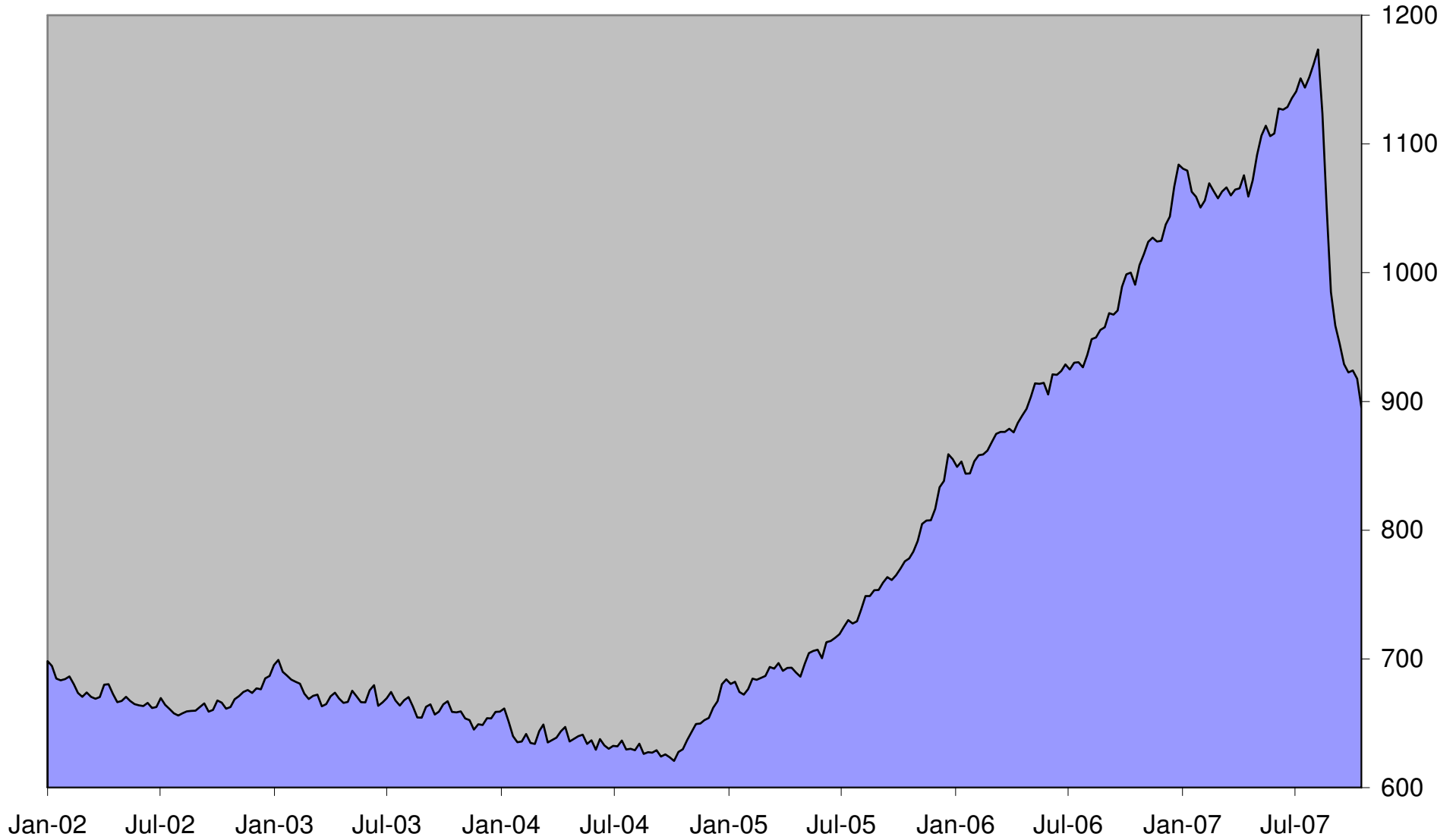


# Symptoms of the Credit Crunch

- Potential financial system sub-prime losses in range of U.S. \$200 billion to U.S. \$400 billion, of which less than U.S. \$50 billion has been recognized
- Additional loan loss problems on credit card, auto, and home equity loans
- A U.S. \$300 billion run on Structured Investment Vehicles
- A worse disruption in the inter-bank market than in the LTCM crisis
- A dramatic tightening in credit lending standards

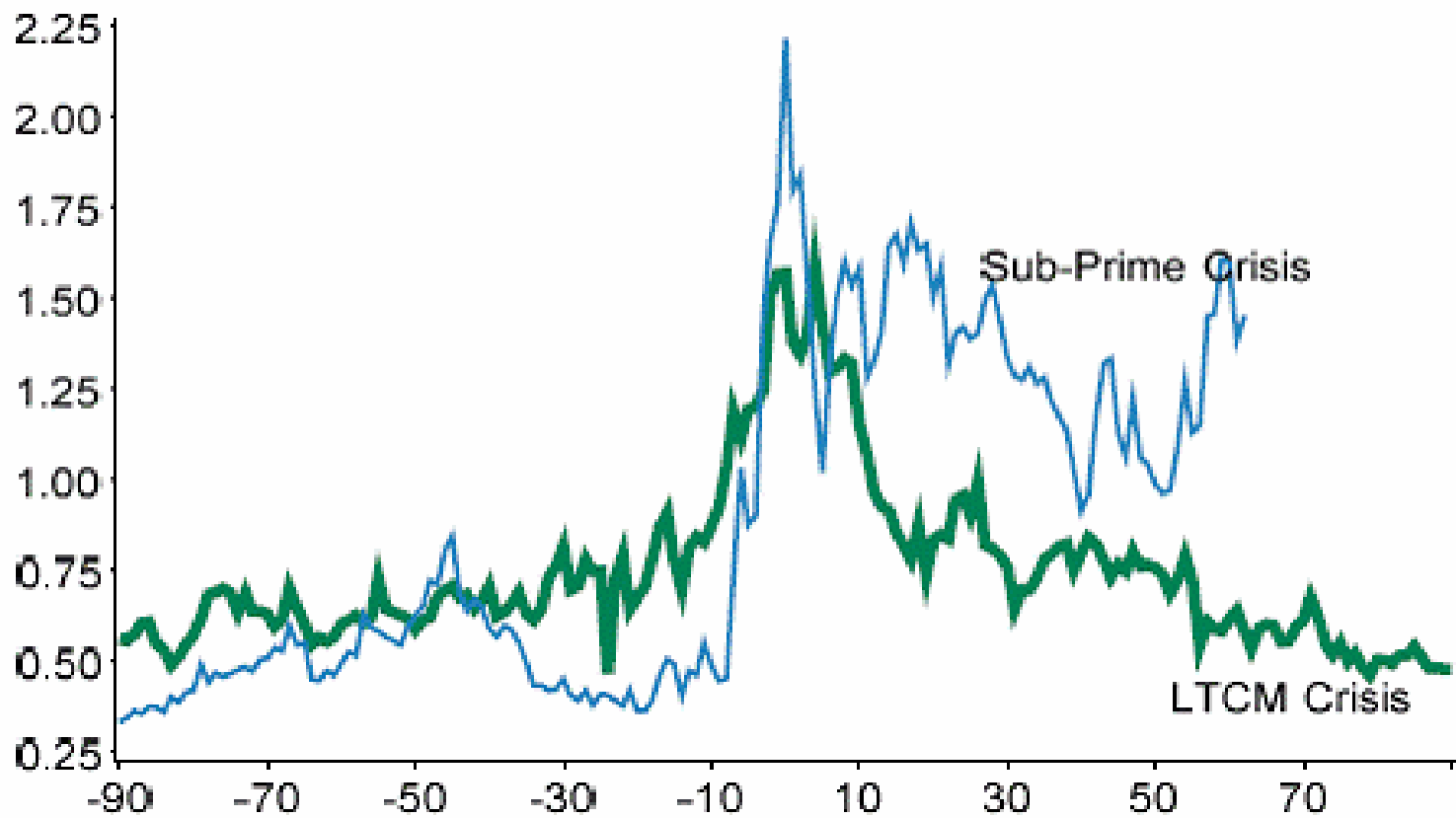
# U.S. Asset Backed Commercial Paper

billions



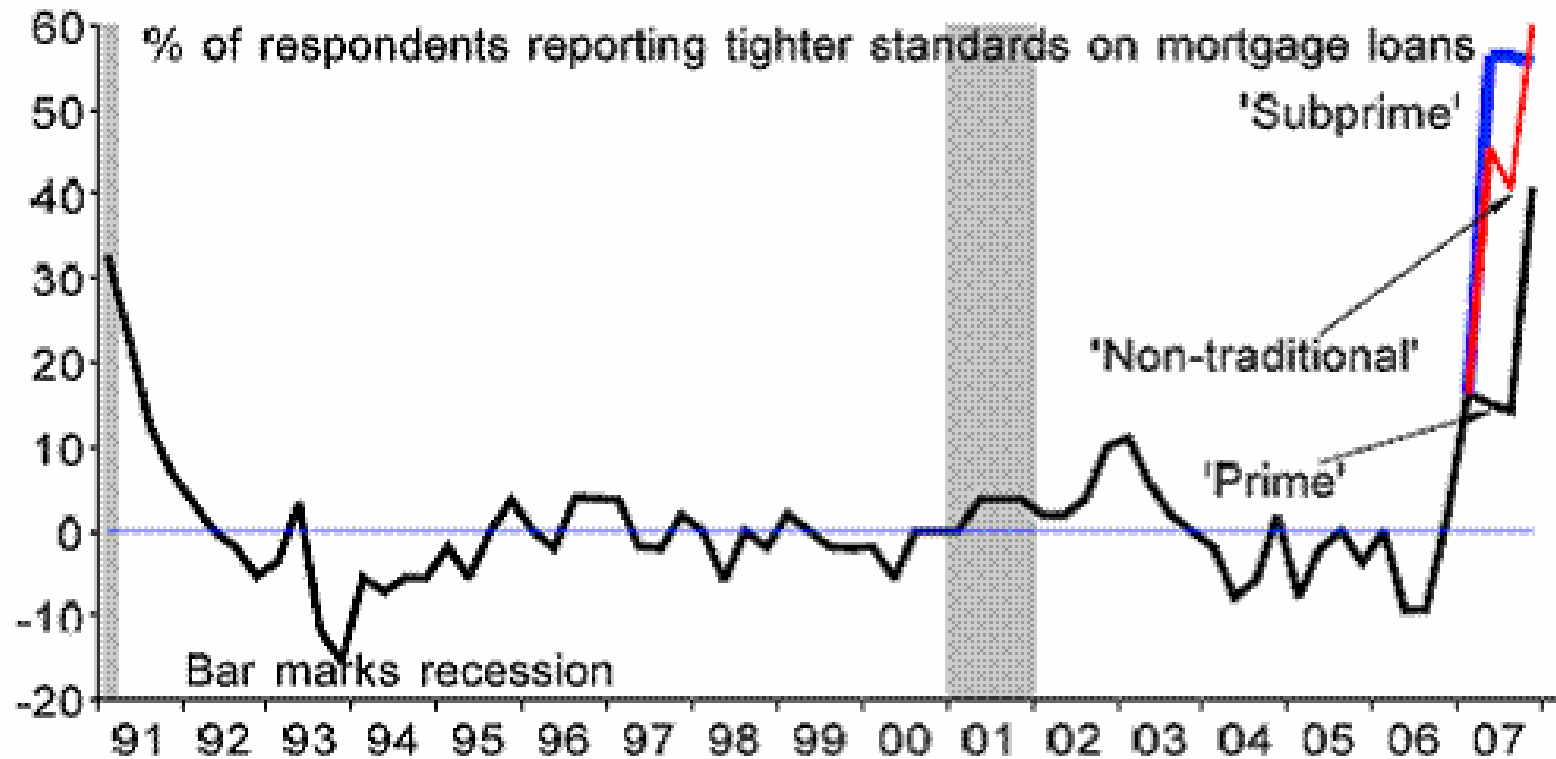
Source: Bloomberg

Chart 2: USD 3m LIBOR – T-Bill



Source: Reuters EcoWin Pro

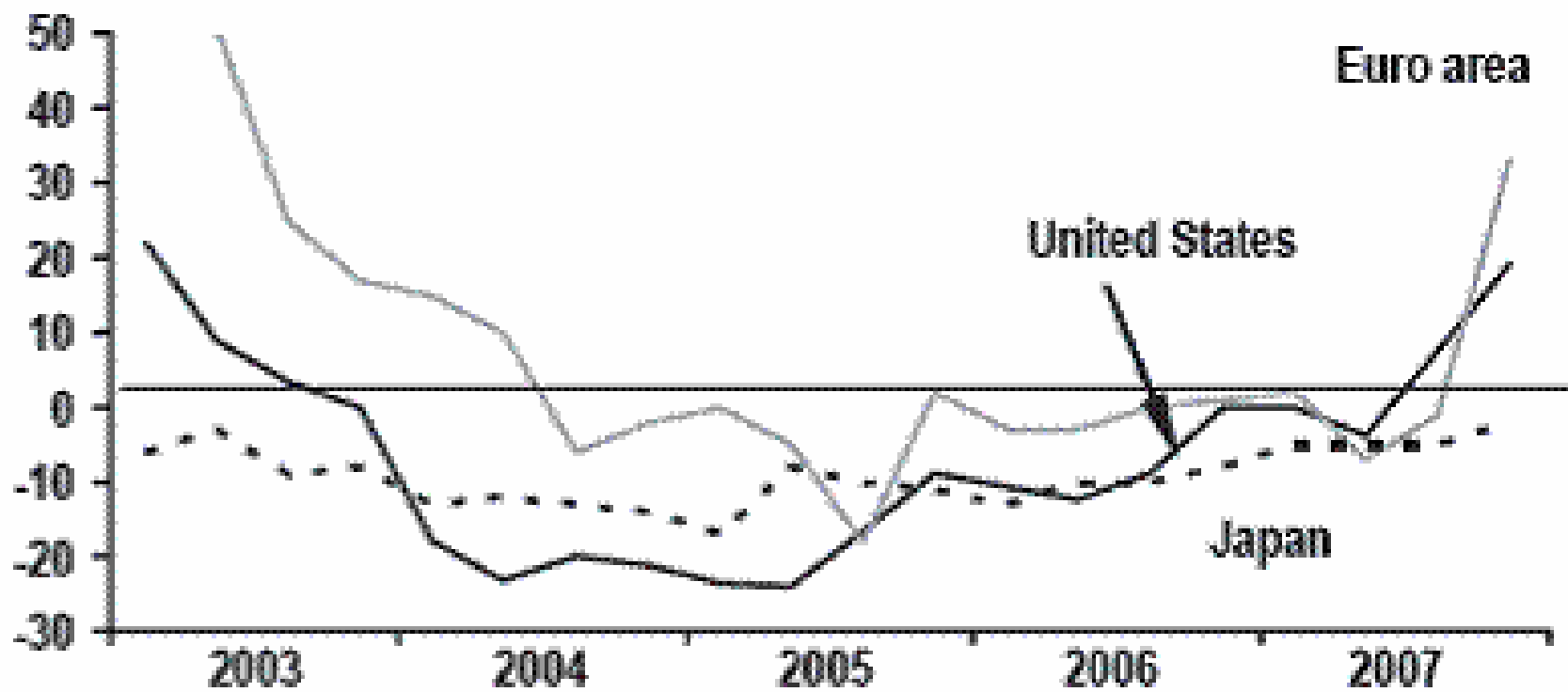
**Chart 4: Ever More Stringent Mortgage Lending Conditions**



Source: Reuters EcoWin Pro

## Credit standards for large nonfinancial firms

Net percentage tightening



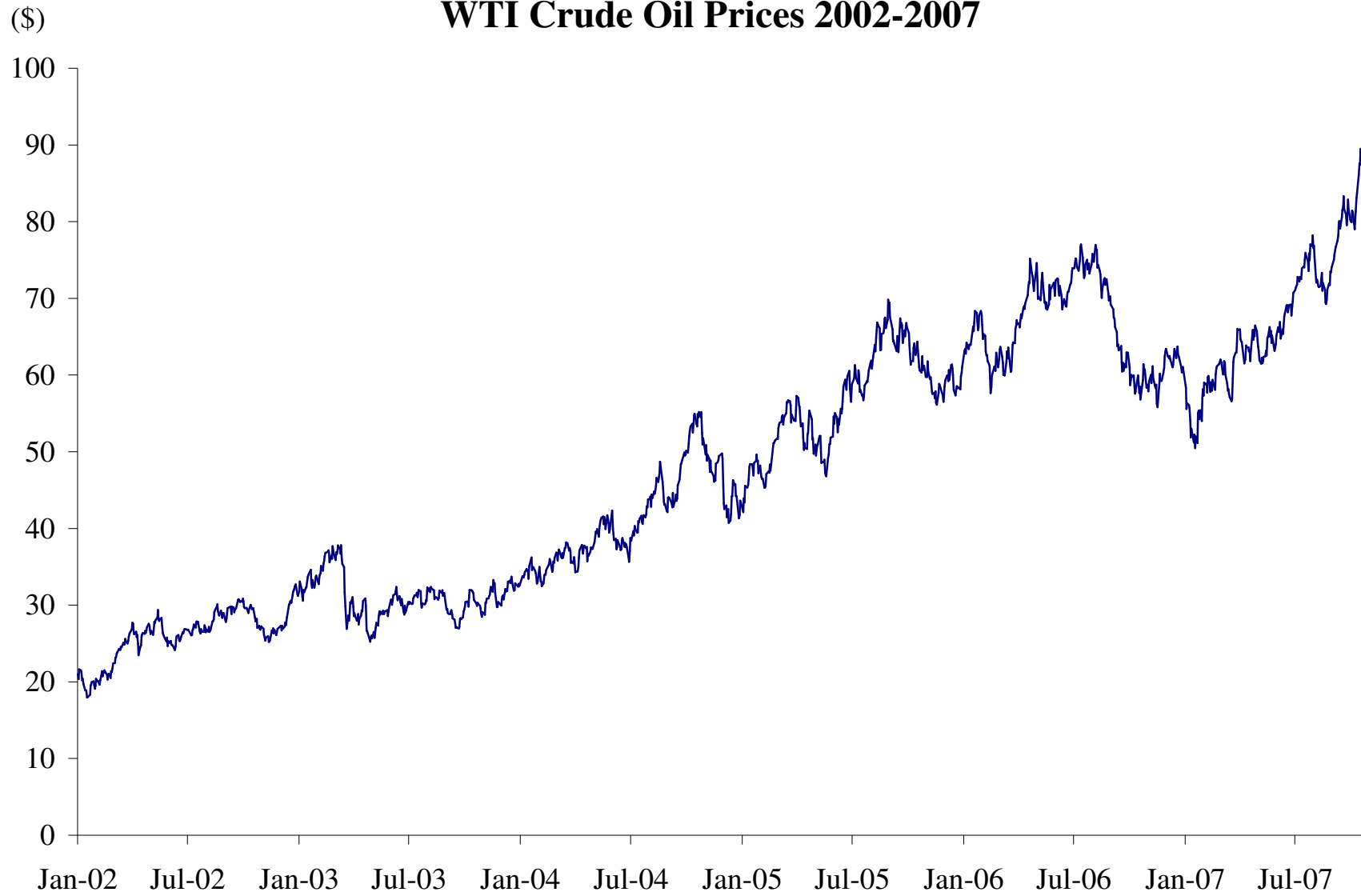
# Basic Monetary and Financial Policy Imperatives

- Provide sufficient monetary policy easing to prevent a major recession
- Encourage the early recognition of loan losses in the financial system and allow for early re-pricing of risk
- Address the lack of transparency in the financial system
- Japanese experience with lost decade underlines danger of moving too slowly on these fronts
- Undertake basic long-run reforms in the way the mortgage market functions

# Constraints on Monetary Policy

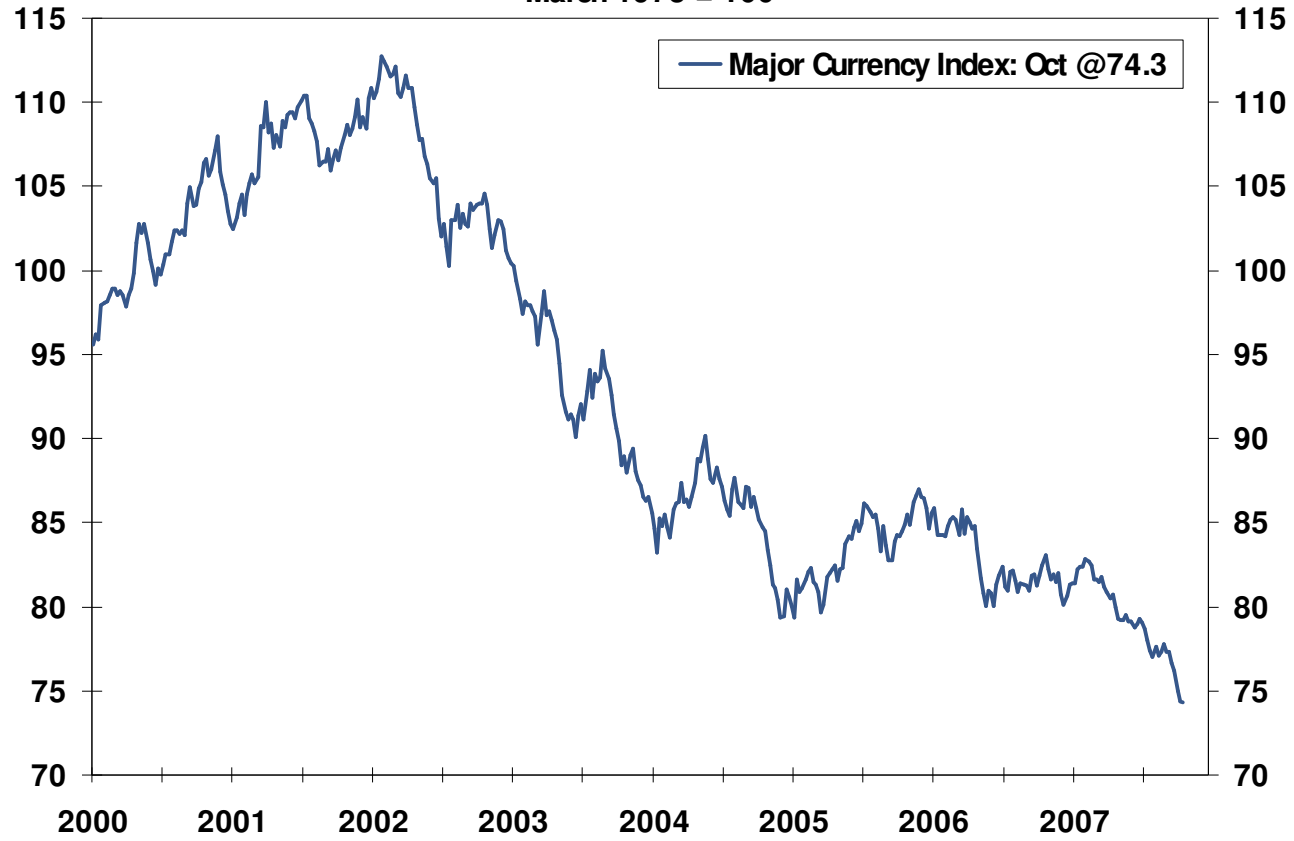
- Elevated international oil and food prices that could negatively impact inflationary expectations
- Risk of a dollar crisis on the back of very weak U.S. balance of payment fundamentals
- After NASDAQ and housing market bust, the Fed is running out of asset markets to inflate
- Unlike LTCM crisis, the sub-prime mortgage crisis involves losses to the overall financial system that is reducing the banks' willingness to lend

## WTI Crude Oil Prices 2002-2007



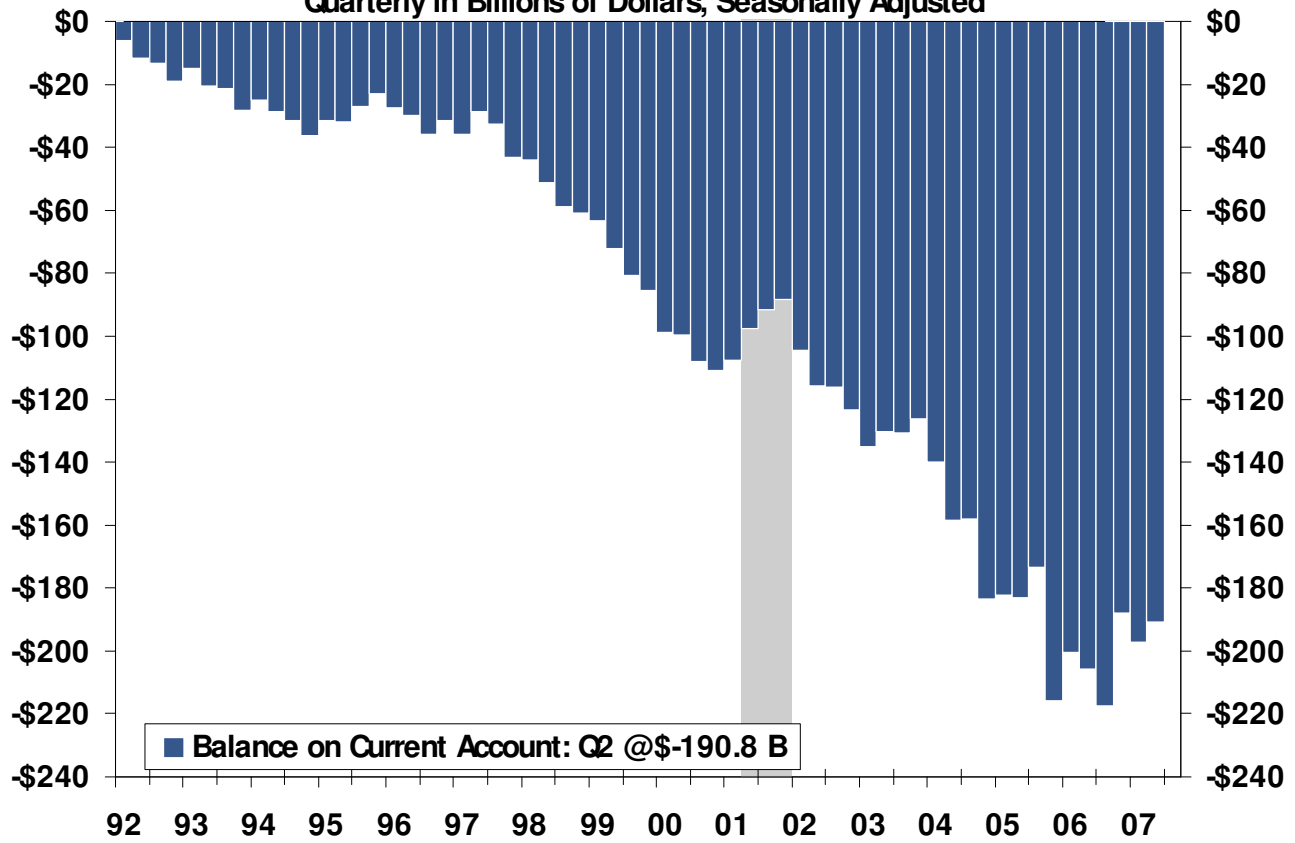
# US Trade Weighted Dollar Major Index

March 1973 = 100



# Current Account Deficit

Quarterly in Billions of Dollars, Seasonally Adjusted



# Immediate Financial Policy Prescription

- Continue to cut interest rates aggressively and look ahead rather than in the rear-view mirror
- Seek monetary and exchange rate policy coordination with the ECB and the Bank of Japan
- Continue to keep discount window wide open to avert seizing up of the banks
- Allow early re-pricing of risk to take place and avoid initiatives like the Super-SIV

# Longer Run Financial Policy Prescription

- Reform Originate-to-Distribute Mortgage lending model that has given rise to sub-prime problem
- Overhaul bank regulatory system that focuses on off-balance sheet items and that covers non-bank financial entities
- Require greater transparency in lending instruments like CDOs and CDOs-squared
- Address the conflict of interest problem with the rating agencies