Trying to understand US financial stress

It is not easy to ascertain the depth of the present financial crisis, to differentiate real economic costs from accounting practices that link asset values to markets where prices are no longer reliable, to get to the essence of the problem out of too many distracting figures. But some illustrative facts could contain useful information to understand it:

a. According to Mortgage Bankers Association (MBA), delinquency rates in the second quarter moved up to 6.41% of all mortgage loans outstanding, the highest rate since 1979 and approximately 32% over its historic average - an excess delinquency of 1.6% -. If there were a final economic loss of 30% on these loans, assuming real estate prices declining within that range, that would transform into a 1.9% loss of the total mortgage stock, or approximately US$ 285 billion. Delinquencies could still go higher, but let us not forget that the excess over historical figures, as an approximation of unexpected events, matters much more under an ongoing business concern evaluation. In that sense, it is illustrative that what is over historic averages would amount to a total loss of US$ 71 billion. Trillions of losses are nowhere to be found.

b. The above mentioned economic losses figures are estimated over the primary asset, that is, the US$ 14.800 billion residential and commercial mortgage stock. In the case of instruments that derive their own value on valuations of this mortgage stock, there is someone losing but also another one gaining. But those losses and gains exist whether the value of the mortgage stock goes up or down, changing only the beneficiary. If the loser under these contracts is too highly leveraged, as some financial entities have shown to be with a 30 to 1 debt to equity ratio, then the possibility of bankruptcy is real. But again, that process could be detonated with primary asset prices going up or down: it just depends on the net bet that has been made.

c. What remains to be seen yet is the economic value of performing mortgages. It turns out that spreads between mortgage rates and comparable US Treasury Bonds went down from historic 150 to 200 basis points to 50 basis points some years ago, when interest rates were at their lowest levels around years 2004 to 2005. That means that most of the mortgage stock was then prepaid and financially restructured under these new lower spread levels. Present day spreads have returned to historic averages, but their impact is limited on the cumulative mortgage stock. Although it is reasonable to expect positive changes in the financial cost function due to IT developments and global easing to capital movements, it is strange to see them go up so easily to old figures, even before this past 12 months events. Most probably, financial companies do have a low equity value in this old stock mortgage business; a sort of underperforming asset in expected terms that could further weaken loan providers in the longer term.

d. Having said that, it is clear that a recapitalization of the financial system is needed. As it is right now, its perceived and effective weakness decreases the power of the monetary authority under the Federal Reserve to guarantee liquidity into the system. It is noticeable that in spite of its efforts for the last year, monetary aggregates such as M1 have been slowly growing between 1 and 2%, on an annual basis. It is true that before they were flat for almost 2 years, and were most possibly too restrictive, but the effects of a deliberate expansionary monetary policy have been certainly lower than expected. The capital weakness of the financial system is clearly to be blamed for it. As to the capital amounts needed, they would have to be determined under economic terms, not repeating mistakes such as using the mark to market rule that can value assets almost randomly – when there is no market -.

e. But there is also good news upon to work on. On an annual basis, US GDP has been growing at 2% for the last 4 quarters. Even though in terms of employment the economy has shown a net job destruction of 600.000 this year, whereas it needs to generate 1.5 million jobs to fully employ the natural growth of its labor force, the economy is growing. In that sense, the fundamentals are stronger than they appear to be, and only a deficiently managed solution on a macroeconomic level to this financial stress could take it out of its present, albeit slower, growth path. Even US$ real exchange rates have been modestly returning to long term trends.

f. Is the US Treasury financial package to buy up to US$ 700 billion mortgage related assets a solution? If liquidity returns to a recapitalized system and monetary aggregates gain strength, then it will work, independently of potential big wealth redistributions between sellers and buyers of these instruments, given the lack of efficient markets providing equilibrium prices for them. The bet is worth taking. Otherwise, there exists the risk of getting into a self prophesized recession. At worst, it will transform into a transfer of wealth, that by itself could be minimized if prices were to be determined on a variable basis dependent on the effective future cash flows to be received from these instruments. In other words, the working of the financial system and its reinvigorated economic growth result is the real priority, not the wealth distribution effects.

g. As for the longer term, one has to wonder if the derivative system over the primary mortgages and any other assets has led to private risk assessments lower than social ones, from an economic viewpoint, allocating resources to areas where there is a net loss for society as a whole. And if so, through which mechanism, evaluating then some kind of regulation that could correct this distortion, conditioned on being less costly than the supposed imperfection per se.

h. And a final comment: these are issues to be technically dealt with. They require a little of ‘sang froid’ and a lot of common sense. And a useful reminder: markets operate well under the right competitive incentives, as our economic history can show. Let us not try to reinvent the wheel.

Manuel Cruzat Valdes
Santiago, Chile
September 24th, 2008