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Liquidity Now!

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The time has come for the Federal Reserve to cut the federal funds interest rate substantially, starting on a path from the current 5.25% to 4.25% and possibly even less. Without such a policy shift, the U.S. economy faces the risk of a significant economic downturn.

Three separate but related forces are now threatening economic activity: a credit market crisis, a decline in house prices and home building, and a reduction in consumer spending. These developments compound the general weakening of the economy earlier in the year, marked by slowing employment growth and declining real spendable incomes.

The current credit market crisis was started by widespread defaults on subprime mortgages. Borrowers with poor credit histories and uncertain incomes had bought homes with adjustable-rate mortgages characterized by high loan-to-value ratios and very low initial "teaser" interest rates. The mortgage brokers who originated those risky loans sold them quickly to sophisticated buyers who bundled them into large pools and then sold participation in those pools to other investors, typically in the form of tranches with different estimated degrees of risk. Many of the buyers then used these to enhance yields in structured bonds or even money market funds.

Many subprime borrowers eventually had difficulty making their monthly payments, especially when teaser rates rose to market levels. The resulting defaults exceeded what investors in the mortgage pools had expected.

Credit risk in financial markets had been underpriced for years, with low credit spreads on risky bonds and inexpensive credit insurance derivatives provided by investors seeking to raise their portfolio returns. With such underpricing of risk, hedge funds and private equity firms substantially increased their leverage.

The subprime mortgage defaults have triggered a widespread flight from risky assets, with a substantial widening of all credit spreads, and a general freezing of credit markets. Official credit ratings came under suspicion. Investors and lenders became concerned that they did not know how to value complex risky assets.

In some recent weeks credit became unavailable. Loans to support private equity deals could not be syndicated, forcing the banks to hold those loans on their own books. Banks are also being forced to honor credit guarantees to previously off-balance-sheet conduits and other back-up credit lines, further reducing the banks' capital available to support credit of all types.

The Federal Reserve correctly stressed its role as the lender of last resort, willing to lend against

good collateral at a discount rate that exceeds the federal funds rate. The Fed also encouraged member banks to lend to other financial institutions against suitable collateral that could then be rediscounted at the Fed. It is not clear whether this will succeed since much of the credit market problem reflects not just a plain vanilla lack of liquidity but also a lack of trust, an inability to value securities, and a concern about counterparty risks.

The inability of credit markets to function properly will weaken the overall economy in the coming months. And even when the credit market crisis has passed, the wider credit spreads and increased risk aversion will be a damper on economic activity.

In addition to these general credit market problems, the decline of house prices and home building will be a growing drag on the economy. Home building has collapsed, down 20% from a year ago to the lowest level in a decade. House prices are beginning to decline, falling 3.4% from 12 months ago and at an estimated 9% annual rate in the most recent month for which data are available. Since house prices adjusted for inflation had surged an unprecedented 70% relative to rents and construction costs between 2000 and 2006, house prices could now fall substantially further.

Falling house prices would not only cause further declines in home building but would also shrink household wealth and thus consumer spending. A 20% cumulative fall in house prices would cut wealth by some \$4 trillion, implying a decline in annual consumer spending by about \$200 billion or about 1.5% of GDP -- enough to push the economy into recession.

A 20% national decline in house prices would involve smaller declines in some places and larger declines in others. Some homeowners could find themselves with loans that substantially exceed the value of their homes. Since mortgages are non-recourse loans, borrowers can walk away with no burden on future incomes. Although experience shows that most homeowners continued to service their mortgages even when their loan balances slightly exceeded the value of their homes, they are more likely to default when the difference is substantially greater.

If defaults become widespread, the process could snowball, putting more homes on the market and driving prices down further. Banks and other holders of mortgages might see their highly leveraged portfolios greatly impaired. Problems of illiquidity of financial institutions could become problems of insolvency.

The negative impact of falling household wealth on consumer spending would be magnified by a decline in mortgage refinancing and the associated withdrawals of spendable cash. Such mortgage equity withdrawals totaled more than \$9 trillion in the decade through 2006, a cumulative amount equal to nearly 90% of disposable personal income in 2006. While there is uncertainty about just how much of this was used to finance additional consumer spending, my own belief is that mortgage refinancing was responsible for a substantial part of the recent sharp decline in household saving and the corresponding increase in consumer outlays. The decline in house prices and rise in interest rates will shrink the future volume of mortgage equity withdrawals, causing consumer spending to decline. While the resulting rise in the saving rate would clearly be good in the long term, permitting increased investment in plant and equipment and reduced dependence on capital from abroad, a rapid rise in the saving rate could push the economy into recession.

Fed action to lower interest rates cannot solve the credit market problems, but it would help the economy: by stimulating the demand for housing, autos and other consumer durables; by encouraging a more competitive dollar to stimulate increased net exports; by raising share prices to increase both business investment and consumer spending; and by freeing up spendable cash for homeowners with adjustable-rate mortgages.

A reduction of the federal funds rate would not be a bailout for individual borrowers and lenders who are suffering from their past mistakes. Any such targeted bailout would be wrong, encouraging more reckless behavior in the future. But it would also be a mistake to resist an interest rate cut and risk a serious economic downturn merely to avoid the indirect effect of helping those market participants.

The Federal Reserve faces a difficult decision because inflation remains a problem. Slowing productivity growth and rising money wages raised unit labor costs by 4.9% over the past year. That plus the falling dollar and rising food prices caused market-based consumer prices to rise by 4.6% in the most recent quarter.

Although the extent of the possible decline in economic activity is uncertain, the economy could suffer a very serious downturn if the triple threat from the credit market, housing construction, and consumer spending materializes with full force. A sharp reduction in the interest rate would attenuate that very bad outcome. Today's 5.25% federal funds rate is relatively tight in comparison to the historic average of a 2% real rate.

Setting the federal funds rate requires a balancing of risks. If the economy would have continued to expand in the absence of a large rate cut, Fed easing now would produce an unwanted rise in inflation, an unwelcome outcome but the lesser of two evils. If that happens, the Fed would have to engineer a longer period of slow growth to achieve price stability. The economic cost of reducing that inflation would depend on the Fed's ability to persuade the market that easing under current conditions is an appropriate risk-based strategy and not an abrogation of its fundamental duty to pursue price stability.

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