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Economy's Fate on Credit Watch

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After one of the most tumultuous weekends Wall Street has ever seen, Americans are asking: How much bleaker is the outlook for the U.S. economy, especially where people work, live, borrow and save?

"The simple answer is: We don't know," J.P. Morgan Chase economist Bruce Kasman said Monday, discarding the confidence forecasters usually demonstrate in predicting the economy's growth rate.

The events of this past weekend could make lenders and investors more reluctant to take risks. If so, that could choke off credit to consumers and companies, strangle the U.S. economy and produce the long-predicted recession.

Or Black Sunday could mark a catharsis in the prolonged financial crisis, the moment when bankers finally faced reality, took their losses and restructured their industry. "If it succeeds, the Treasury's gamble," refusing to aid Lehman Brothers Holdings, "could have a substantial confidence-boosting effect, and might eventually be seen as the first key step on the road to recovery," said Marco Annunziata, economist for UniCredit Markets in London. "Investors will have reason to be more confident in the self-healing ability of the system, and to believe that the deleveraging process can continue without disruptive consequences."

Early signs were mixed. When markets opened Monday, the nightmare didn't arrive. To everyone's relief, financial markets functioned smoothly. Stock prices around the world fell. Early declines seemed modest next to headlines that Lehman Brothers was filing for bankruptcy, Merrill Lynch was selling itself to Bank of America and insurer American International Group was seeking someone with deep pockets, but U.S. stocks dropped sharply at day's end.

More worrisome, the already-wide gap -- the "spread" in market lingo -- between yields investors demand on investment-grade securities and those on safe U.S. Treasury securities widened to March levels, a reflection of deteriorating confidence among investors and a measure of the extent to which financial conditions are constraining the economy. The unwelcome prospect that banks and financial houses would become more reluctant to lend led some on Wall Street to plead to the Federal Reserve for an offsetting cut in the interest rates it controls.

A lot turns now on how much wider those spreads get. "How much does the price and availability of credit change? Where are we going to be three weeks from now in terms of credit spreads, the actual rates consumers and corporate pay?" asked Mr. Kasman. Mortgage rates have fallen since the government seized control of mortgage giants Fannie Mae and Freddie Mac, he noted, wondering how much of that might be reversed in coming days.

The willingness and ability of financial institutions to lend is among the most important uncertainties confronting the economy. With big losses eroding their capital cushions, the firms either have to raise new capital or to contract lending to levels commensurate with reduced capital. Raising capital is tough, as AIG, Freddie Mac and Lehman learned. Contracting lending may be prudent for an individual firm, but devastating to a modern economy that relies on credit to fuel growth.

All this comes as the U.S. economy is in what former Federal Reserve governor Laurence Meyer describes as a "danger zone," close to, if not in, recession. Employers have reduced payrolls every month this year, eliminating 605,000 jobs in all. Just yesterday, Hewlett-Packard announced plans to cut nearly 25,000 jobs. Since December, the unemployment rate has climbed to 6.1% from 5.0%. And the Federal Reserve said Monday that output of American factories dropped a sharp 1.1% in August, mostly, but not entirely, because of auto-industry cutbacks. Factory output outside autos has fallen or been flat for five months now.

Still, the biggest financial shock since the Great Depression hasn't, at least so far, been accompanied by the usual symptoms of deep recession. The economy, for instance, shed more jobs in the first eight months of 2001, after the stock market bubble burst, than it has this year. And the government says the economy contracted in the last quarter of 2007, but grew in the first and second quarters, and forecasters say it appears to be growing in the third quarter.

Why isn't it worse? "It's a great question," says Mr. Meyer, now a private forecaster. "The economy was really strong going into the housing correction in 2006. It had the strength to withstand the housing shock. Then you get the credit shock. The Fed eased, by past perspective, incredibly aggressively. That significantly offset the deteriorating financial conditions, which, with rising oil prices, were enough to stagger the economy, bringing it close to recession. But you've got to appreciate the resiliency."

As housing, autos and financial sectors deteriorated, an export boom arrived at just the right moment. Indeed, foreign trade has provided the bulk of growth in the U.S. for the past several months. With economies outside the U.S., particularly in Europe, slowing substantially, the U.S. export boom is likely to wane.

In short, the worst for the economy may still lie ahead. Even before the weekend's events, 14 of the 51 economists responding to a Wall Street Journal survey earlier this month predicted the U.S. economy will contract in the fourth quarter as the adrenalin of fiscal-stimulus checks and earlier rate cuts wane. The average of the 51 forecasts was fourth-quarter growth at a meager 0.7% rate, a pace likely to produce rising unemployment. Monday's drop in oil prices -- though welcome -- is best seen as a symptom of waning global demand than a source of strength.

The continuing decline in house prices is eroding homeowners' wealth and discouraging new construction, but the economic ill-effects are greatly magnified as house prices erode the value of securities held by major financial firms. "Mortgage credit losses deplete the equity capital of leveraged financial institutions and persuade them to reduce their financial leverage," Goldman Sachs economist Jan Hatzius said in an analysis presented at the Brookings Institution last week. "This reduces the supply of credit to households and nonfinancial businesses."

He puts the losses on residential-mortgage loans at $636 billion between 2007 and 2012, assuming house prices fall 10% from mid-2008 levels. As financial institutions pull back, those losses could reduce the supply of credit in the U.S. economy so much that the economy's growth rate would be reduced in 2008 and 2009 by an average of 1.8 percentage points a year. And that huge effect assumes Fannie and Freddie continue to expand aggressively their mortgage businesses.

None of this comes as a surprise to the former Princeton University professor who now is chairman of the Federal Reserve, Ben Bernanke. He made his mark in academia arguing the importance of what he and his collaborators called "the credit channel," the ways in which the financial health of borrowers and banks affects the economy and helped cause the Great Depression.

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