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US economy in need of urgent action

William Rhodes
INSIGHT

In March last year I warned in this newspaper that the global "Goldilocks" economy and markets would face a material correction within the next 12 months and there was a need to exercise greater prudence in lending and investing.

This warning was ignored by most in the private and public sectors. Unfortunately, much of what I feared would happen has materialised.

From the twin origins of the subprime fallout and the dislocation of the mortgage-backed securities markets, there has been a crisis of confidence that has already led the US economy into a period of low growth, or even a recession. Add to this mix a weak dollar and the trend of rising inflation across the world driven by high food, energy and commodity prices and it is clear the future is still fraught with risk and uncertainty.

With decoupling probably a myth, there will most likely be a worldwide economic slowdown should the US downturn be a protracted one. While there are signs that the credit markets may be bottoming out, it seems likely that the housing market will remain in its downward spiral for the remainder of the year.

The impact on the real economy could be even more serious should the US consumer decide to cut back significantly on spending. The question then becomes: what should be done to ameliorate the current slowdown before it becomes a full-blown economic crisis with potential worldwide consequences? Specifically, I would like to mention three areas where immediate action should be taken in order to restore confidence in the markets.

First, I would encourage the Federal Reserve to continue showing flexibility in providing liquidity to the financial markets. The Fed has modified the requirements of its Term Auction and Securities Lending Facilities several times in the past few months to help ease the liquidity needs in the market. Its efforts surrounding the Bear Stearns situation, where the discount window was opened to investment banks and brokerage houses, were critical to maintaining stability in the system. The Fed needs to continue to respond proactively to developments and consider further modifications to its facilities as necessary. All of this should be done in c-ordination with the world's leading central banks.

Second, the government and regulatory authorities need to make greater efforts to support the mortgage markets.

Recently, there have been many new ideas and initiatives coming out from the US Congress, economists and the financial community. These include the Senate's recent passing of a bipartisan package of tax breaks, credits and grants as well as Congressman Barney Frank's and Senator Christopher Dodd's plans to let the Federal Housing Administration insure refinanced mortgages after lenders reduce principal to struggling homeowners. Any solution will require some government or federal funding and must be dealt with as an immediate priority to halt the downward spiral in US property prices.

Last, professionals in the financial industry and regulators need to re-examine the weaknesses that have surfaced in the current turmoil. Recently, the Institute of International Finance (IIF) released a report that made some recommendations to improve market practices.

One of the important issues that the institute is looking at carefully is that of fair value/mark-to-market accounting, which has proven valuable in promoting transparency and market discipline over the past 10 years. However, we have seen that in certain extreme conditions with very limited liquidity for various securities, this accounting approach may have an unintended consequence of prolonging liquidity difficulties and exacerbating the current crisis.

Paul Volcker, in his recent speech at the New York Economic Club, raised questions about the usefulness of mark-to-market accounting, particularly its extension in uncertain and illiquid markets.

The IIF has made specific recommendations on how this approach might be refined to take into account extreme market conditions. These recommendations need to be worked on in a timely fashion in conjunction with the regulators and international accounting bodies.

The action steps I have recommended above need to be considered proactively and with a sense of urgency. If implemented, they should help in restoring the US economy to an even keel and limit the global impact of the current correction. While the picture ahead is still unclear, what is needed is the courage to make tough decisions and to implement corrective measures expeditiously.

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