The real economy, already weak before the financial market meltdown, is now in a full-fledged recession. The first quarter of negative growth has already been recorded. The current quarter is likely to continue in negative numbers and we will have reached the technical definition of a recession — defined as two back-to-back quarters of negative growth.

The outlook for the next six months is not positive. Consumers are retrenching their spending patterns and will likely provide little of the typical spending boost from the holidays. Without this seasonal spending, corporations will reduce orders and continue to lay off workers. Growth will remain weak for some time.

The new presidential administration will struggle with its inherited macroeconomic problems. Congress is likely to pass a stimulus package before the end of the Bush administration, but whether it is signed will depend on the composition of the package and the evaluation by the Bush team of its likely macroeconomic impact.

President elect Barack Obama's team will focus quickly on its own macroeconomic plans for restimulating the domestic economy. Tax cuts will be forthcoming, as will an increase in spending by the federal government. There will be little focus placed on the sharply rising budget deficit — at least for the first year or so.

The Federal Reserve has already reduced interest rates and injected historically large volumes of liquidity into the system. But providing the liquidity does not guarantee that institutions will resume providing much needed credit flows to the economy.

The internationalization of the crisis resulted largely from a lack of transparency in European financial markets coupled with a lack of regulatory oversight. Regulators were surprised by the extent of European participation in the securitized mortgage derivative market. And they were unprepared for the lack of capitalization of many individual banks.

But this is not a systemic problem that could be corrected by a new Bretton Woods II. It is not a problem brought about due to capital movements or capital flows. The exchange rate system had nothing to do with the crisis. The two fundamental areas of focus for the International Monetary Fund (IMF) have been the movement of capital and the exchange rate system. The IMF is not a regulator of capital markets. That is an area that the Bank for International Settlements (BIS) handles, and should remain outside the IMF framework.

Leaders' Meeting

It is encouraging that the leaders did not set in motion a plan to create a "new Bretton Woods system." They did, however, establish a five-month plan that should result in a report of recommendations at the next G20 leaders meeting in April 2009. Significantly, the majority of the tasks set out for their finance ministers reflected a desire to make the regulatory process more transparent and consistent across countries, rather than focus on a major change in the degree or kind of regulations per se. This is consistent with the view expressed here that the current process was more the result of lack of enforcement than of a lack of regulations. The leaders have begun a process of regulatory review, modernization and co-operation that should serve the system well in the future.

bank and investment bank balance sheets. One of the consequences of the Sarbanes/Oxley legislative reforms was the concept of "mark to market" accounting for assets. As the value of the securitized mortgages fell, the balance sheets weakened dramatically. And essentially thus began a downward spiral.

Now the Fed and Treasury faced new question with Lehman Brothers. Should the firm be bailed out or should it be allowed to fail? The decision was reached to simply allow failure of investment bank. Then came the problem of Bear Stearns — another major player in the investment bank area. This time for a variety of reasons the Fed and Treasury decided to work on saving the company. Then the Treasury recognized that AIG was deeply involved in insuring the various derivatives built on the securitized mortgages, and that it would require an infusion of capital to remain solvent. And now the financial crisis was now fully blown.

As of late November 2008, the administration's financial rescue plan has not convinced the markets that its approach will solve the problems. While the Treasury has started to inject funds directly into weak banks via stock purchases, it has not yet begun to purchase securitized mortgages. Moreover, Secretary Paulson announced in late November that the Treasury would not be purchasing distressed assets. He argued that providing capital to financial institutions was more important that purchasing distressed assets. Additionally the Treasury has not yet addressed the question of credit default swaps. These instruments swamped the size of subprime mortgage defaults and played a major role in the current problems of insolvency.

Moreover, there is continuing confusion about how the existing mortgages that are undergoing foreclosure procedures will be handled. The Congress wants the administration either to purchase failing mortgages directly and renegotiate their terms to lower the outstanding principal and reduce the interest rates or to force financial institutions to renegotiate them. Neither approach has yet been worked out.

In addition, the U.S. Federal Reserve System has continued to inject significant amount of liquidity and is likely to reduce interest rates further. But there is still a disconnect between the provision of liquidity and the resumption of lending by financial institutions. In classic monetary economic terms, the Fed is attempting to push on a string. That is they can inject liquidity, but they cannot force lending to take place.

Process of De-Leveraging Not Complete

The process of deleveraging has not yet been completed. The next area of credit problems is likely to centre on consumer credit cards. Americans have long used credit cards significantly more aggressively than have most other nations. Many people hold several different credit cards and run up balances on each. People typically make minimum payments — which are not large enough to reduce the outstanding balance. As a result, the interest charges continue to increase as does the outstanding balance. Financial institutions will likely re-examine the use of credit cards in terms of the credit worthiness of card holders and will begin to reduce credit limits for individuals. This will result in a further reduction in consumption by individuals. Perhaps a first sign of the credit card problems was seen in late November. American Express applied to be a bank-holding company that would provide significant access to Federal Reserve resources.

Chapter 10
The View from Washington

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The financial crisis that had its beginning in the subprime mortgage market in the United States has spread to the rest of the world's financial markets. While some argue that this calls for a total revamping of the Bretton Woods system of the international monetary system, a strong case can be made for a much less grandiose approach. Of course, the answer depends largely on how one evaluates the causes of the crisis and the potential solutions to the crisis.

In the U.S., the crisis was largely precipitated by excessive mortgage lending to weak credit-worthy borrowers. This lending was facilitated significantly by the substantial growth in direct purchases by Fannie Mae and Freddie Mac of mortgage paper from lending institutions. These mortgages were bundled and securitized and then sold to investors. As long as the housing market continued its upward price trend, the system was sustainable. Banks could foreclose on an individual bad loan and easily recoup their exposure by reselling the property. When the housing bubble broke, the system started to implode.

If the only weakness had been risky loans, the financial system could have shaken off the rise in foreclosures without significant difficulty. However, the securitized mortgages had been used as the basis of derivatives, swaps and credit default swaps. More and more ways were developed to capitalize on the increased level of securitized mortgages issued by Fannie and Freddie. Unfortunately, these complicated derivatives and swaps were not well understood by either the regulators or the risk management committees of the investment banks or insurance companies such as AIG. As a result, no one fully recognized the dangers and risks in the system.

When the housing bubble broke, the balance sheet weakness of Fannie Mae and Freddie Mac became apparent. The U.S. administration sought congressional support for recapitalizing Fannie and Freddie. While at first, this seemed to calm the situation, it was short-lived relief. Markets started looking at the various institutions that issued derivatives, swaps and other products based on the securitized mortgages.

That is fundamentally how we the financial market broke down.

Lack of Regulation Not Only Cause

It was not lack of regulation per se. It was more a problem of enforcement of regulations. And it was a problem with the management of investment bankers. The risk management teams failed to recognize the dangers of the new instruments.

With the fundamental problems at Fannie Mae and Freddie Mac, the Treasury and Federal Reserve set in motion plans to inject liquidity into the markets — and to begin close supervision of the two institutions. But this action focused attention on the fundamental problems dealing with the mortgage market.

Markets started re-evaluating their estimates of the value of securitized mortgages and those instruments dropped substantially. Unfortunately, the drop in value weakened