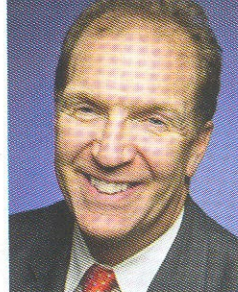


Current Events

By David Malpass, CHIEF ECONOMIST,

BEAR STEARNS & CO.



How Hard a Landing?

IT WILL TAKE MONTHS TO JUDGE THE FULL IMPACT OF THE August credit shock on the real economy—on job growth, production and home construction. The still open question is, how hard will the landing be? I expect we'll muddle through with a global slowdown, short of a recession. But three factors could lead to a harder landing: the massive letdown in credit conditions from the extraordinary 2003–06 period of excess liquidity creation, low real interest rates and dollar weakness; the drag on future growth from the disruption of the securitization process, an unexpected change in the outlook that's just beginning to impact growth; and the Fed's likely caution toward rate cuts.

The U.S. economy has many strong growth engines—flexibility, innovation, a healthy reliance on small businesses, more than 140 million remarkable workers and growing exports to meet the global boom. Growth data into August was solid.

But at least one over-oiled engine broke in August: the securitization process used to connect commoditized borrowers to broad lending pools. The importance of this to credit markets had grown large in recent years, taking market share from the more traditional lending processes in which the borrower and lender know each other.

Securitization will rebuild itself over time, but with less horsepower and more costs—simpler derivatives, more careful risk assessment, less aggressive use of commercial paper and more regulation. Bank loans and equity capital can replace some of the credit market shrinkage. But even with these replacements, the change in the credit process, like sand in gears, will bring slower GDP growth, less profit and fewer new jobs.

No Quick Recovery

Financial markets recovered relatively easily from shocks earlier in the decade, such as the California energy crisis, spikes in the price of gasoline, Hurricane Katrina and the downsizing of auto production. Despite the 2006 collapse in mortgage equity withdrawals and home building, new highs were set by July 2007 in jobs, personal income, consumption, profits and equity markets.

But the ongoing credit shock probably won't subside as quickly as earlier shocks. At a minimum the coming slowdown will likely be the deepest in the five-year expansion. Many transactions, big and small, will be delayed or canceled as new, more expensive financing is sought. Loan losses have to be assessed, reported and absorbed by the various parties. Jobless claims were remarkably low pre-August but will likely jump in coming months. Weeks into the shock, rudimentary short-term credit markets are still not functioning smoothly. Banks aren't committing to short-term loans and longer-term swaps

with one another as readily as before, and the preference for ultra-safe Treasury bills, despite their low yield, remains intense.

Depending on confidence, the slowdown could easily turn into a recession. Some companies will reduce hiring and investment plans, which will circle back as job uncertainty and slower consumption growth. If job uncertainty turns into an actual reduction in U.S. jobs, then consumer resilience, a hallmark of this expansion, will fade. With more cautious business spending and some finance-related weakness in construction, GDP could decline—recessions usually show two consecutive negative quarters.

A key variable in the hardness of the landing is the value created by all the past liquidity. If it was used well, the landing will be cushioned by past gains and shouldn't be hard. In contrast with that of the 1970s, much of this decade's excess liquidity was channeled into solid investments—stronger corporate balance sheets, profit-oriented investments abroad and major improvements in the capital structure of developing countries. However, another part of the hyperliquidity simply bid up the price of existing assets, whether commodities, bonds, land or antiques. Those prices will probably be tested severely in coming months as credit markets proceed with their restructuring. The hard-landing risk is that economic activity will slow until prices hit bottom, a self-reinforcing downturn.

As growth shows clear signs of slowing, the Fed will likely cut its funds rate. Lower rates will help some but probably can't reverse the slowdown or counteract the losses already incurred. Nor can the Fed roll the clock back to the heady liquidity days of 2004–06; that environment combined very low interest rates with aggressive investors eager to embrace risk, neither of which is in sight today.

The Fed will probably be slow to cut interest rates in this downturn, just as it was slow to cut them in 2001 and slow to hike them in 2004 and 2005. The Fed will come up with many reasons for its current foot-dragging: The economy rebounded after recent shocks and hasn't shown much weakness yet; several market developments were a necessary rollback of extremes; the discount-rate cut, though little used by banks, met with initial praise; headline inflation problems still linger from dollar weakness earlier in the decade.

But more important, the Fed may also harbor the desire—too late, in my view—to fight “moral hazard,” the market's assumption of rate cuts when problems arise. One constructive outcome of a slowdown, though unlikely, might be a resolution by the Fed to recognize changes in the value of the dollar as an indicator of tight or loose monetary policy. Instead of resisting moral hazard during downturns, the Fed should be working harder to avoid Fed-driven boom-bust cycles in liquidity. **F**



David Malpass, chief economist, Bear Stearns & Co.; Paul Johnson, eminent British historian and author; Lee Kuan Yew, minister mentor of Singapore; and Ernesto Zedillo, director, Yale Center for the Study of Globalization, former president of Mexico, rotate in writing this column. To see past Current Events columns, visit our Web site at www.forbes.com/currentevents.