Publisher's Letter

Contributed by PT Editors
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THE ECONOMY: DOWN AND DOWNER

Almost out of options, there’s one possibility left for the American authorities–raise interest rates. The result: for starters, a stronger dollar, lower oil prices, and an incentive to save more and spend less.

Earlier this year, PT published a speech by New York financier Wilbur Ross. Ross estimated “the probable total damage from this economic crisis is something on the order of $1.1 trillion.” He went on to say, “there’s another huge but unclearly defined time bomb called credit derivative swaps (CDS), in which one party contracts to pay another party in the event that a particular debt instrument defaults. According to the International Swaps and Derivative Association (ISDA), if you netted out all of the trades against each other, the net credit extension is $2.3 trillion.” Recently, a research firm, Bridgewater Associates, estimated loses from the credit crises could equal $1.6 trillion. So, the damages lies somewhere between $1.1 trillion and $3.4 trillion.

Ian Morris, Chief Economist at HSBC in New York, reported that thus far, banks and financial institutions had written off $396 billion. (More recently, that number has climbed to well over $400 billion.) In response to a question, he suggested that a number of these institutions had written off securities to zero, when in fact they might be worth something. But, that if the higher estimates of total losses were close to being correct, “the end result would be a major recession.”

One of the problems with the current financial crisis is that no one knows: no one knows what or how much the banks have written off, what the total losses are, and more importantly, where they are. How much is in the US, how much overseas? But, if any of these numbers are right, they suggest that the financial crisis is still in its early days.

The policy implications? As recent actions by the US government suggest, credit is the mainstay of a consumer economy. And, if banks and financial institutions are shrinking their balance sheets, then there’s less credit, resulting in less if not negative growth.

US officials are close to being out of options: they’ve lowered interest rates, thrown open the discount window, and bailed out institutions. Each has helped for a while, but the underlying problems haven’t gone away: (very) poor credit decisions (greatly) amplified by risky financial instruments.

There is one possible option that runs contrary to the conventional wisdom but has its merits: save the dollar—raise interest rates. Last August, the fed funds rate was lowered to 5.25%. As of April 30, the Fed Funds Rate stood at 2.0%. In August 2007, the price of a barrel of oil stood at about $75 barrel. It is now at $125 per barrel, having seen highs of $147. A euro was $1.35. Today, it is $1.58.

The likely result? For starters, a stronger dollar, lower oil prices, and incentives to save more and spend less. Raising interest rates will also accelerate bank’s efforts to shrink their balance sheets and cut credit—bad news for a consumer driven economy. But with Congress on hand to bail out all but the most hapless borrowers, the potential benefits seem likely to far outweigh the obvious risks. A silver bullet? No. But a good place to begin.