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Credit crunch will last into '09, economists say

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A month ago today, a global credit freeze – so severe that it seemed capable of pushing the world economy into a depression – prompted the White House to unveil a plan to pump hundreds of billions of dollars into the nation's financial system.

Despite some slight easing over the past week, interest rates remain at historically high levels, making it difficult for banks and corporations to obtain needed loans. Interest-rate spreads – a major yardstick for measuring credit flows – remain at heights not seen since the post-Cold War recession of the early 1990s.

Economists say it could be well into 2009 before the credit market begins to approach a semblance of normalcy. Unless the credit crunch is resolved, the current recession could be much deeper and longer than it otherwise would be. Already, the problems have caused stock markets to plunge worldwide.

The credit market has become increasingly constricted over the past year, as the impact of the U.S. housing bubble's collapse spread throughout the world's financial markets. The problems associated with mortgage-backed securities have made financiers skittish about lending to each other.

“The big issue is how to restore confidence,” said Rafael Bostic, a former senior economist at the Federal Reserve who is now an economics professor at the University of Southern California. “Right now, there's still a bit of frenzy and chaos in the marketplace.”

The Bush administration's $700 billion federal bailout program is designed, in part, to restore that confidence by bolstering the stability of financial institutions.

But even when it is fully implemented – late this year or the beginning of 2009 – “there's a question of whether people in the market will have the confidence to loan to each other, or whether they believe their loans will be paid back,” said Dan North, chief economist for Euler Hermes, which insures accounts receivable.

One reason that credit remains sluggish is because most of the money set aside in the bailout package has yet to filter its way into the financial system.

To fund the program, the Treasury Department must float billions of dollars'worth of Treasury bills on the global marketplace, a process that takes several weeks. At the same time, the department must appoint a cadre of employees to oversee the program. It may take until Thanksgiving before the program is fully operational.

“We have to wait at least another month for these actions to have an effect,” said Campbell Harvey, professor of international investment and finance at Duke University in Durham, N.C. “That creates a problem in terms of confidence, since the actions that people have been talking about haven't really taken place yet.”

The first phase of the program, announced last week, is to buy $250 billion of preferred stock in banks, in the hope that they will turn around and lend that money to companies or consumers.

But the government has until Dec. 31 to fund its obligations under the program. So it may be the beginning of next year before the full effect becomes apparent.

The timelines for the other programs under the bailout, including the initiative to buy back mortgage-related securities, are similarly long. In the meantime, the credit market could worsen, dragged down by mounting evidence that the global economy is sliding into recession.

Market watchers who track the credit crunch say there are several methods for monitoring whether the market is beginning to ease, including:

▪Interbank loans. The world's largest banks lend money to each other through an international financial network that passes through London. The London Interbank Offered Rate, or LIBOR, is the benchmark for interest rates on those loans. The lower the LIBOR is – and the closer it gets to the interest rate on U.S. Treasury bills – the easier credit conditions are.

Typically, the LIBOR is only 50 basis points, or 0.5 percent, above the T-bill rate. As of Friday, there was a gap of 397 basis points – a significant improvement from its peak of 465 a week before.

▪Commercial paper. Corporations often use "commercial paper," or short-term IOUs, to make up for hiccups in cash flow. When there is a large gap between high-quality AA commercial paper and slightly lower-quality A2/P2 paper, that signifies that investors are skittish about taking on too much risk. Over the past year, that gap has been at its widest levels since the measurement was introduced eight years ago.

But whether the $700 billion bailout – combined with hundreds of billions of dollars' worth of bailouts from abroad – will be enough to bring the credit market back to normalcy is still unknown.

Most analysts are skeptical. The longer the crunch lasts, the worse its effects will be. And the timelines for the various bailout packages imply that credit will remain tight for months.

Brian Bethune, director of financial economics at Global Insight, an economic analysis firm in Massachusetts, estimates that the Federal Reserve will probably need an additional $200 billion to inject more capital into the banking system.

"At some point in the near future – probably after the election – the Fed will have to go back to Congress to ask for more money," Bethune said. "The Fed's fighting two battles now: the battle of the economy and the battle of the financial markets. It is a major, major challenge."

Even if the Fed does get additional funding, Bethune estimates that it could be the middle of 2009 before the credit crunch substantially eases. And even after that happens, there will be no return to the easy credit of the past decade. In other words, unless borrowers have a sterling credit record, it will be hard for them to get low-interest mortgages, auto loans, credit cards or student loans.

Ryan Davies, a commodities trader with Titan Investors in San Diego, predicts that it will take a while before the bailout package has any significant effect. He said that no matter what the government does, the credit crisis is partly out of its control, since so much of the problem is related to faulty mortgages.

"Until home values stabilize, the value of (mortgage-related securities) is going to continue to decline, and there's not a whole lot the government can do about that," Davies said.

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