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## The Global Financial Crisis and the Florida Economy: One Year Later

Slightly more than a year ago, the global financial crisis struck like a full force gale. Financial institutions and other investors started to report massive losses on collateralized debt obligations (CDOs) - bonds backed by sub-prime mortgages. As the default rates on sub-prime mortgages soared, buyers of CDOs abandoned the market, liquidity evaporated, the value of CDOs plummeted, and the securitization of home mortgages collapsed.

If the shock had been contained to the subprime segment of the credit markets, then the economic effects would have been adverse and harsh, but not debilitating. Instead, a chain of events was set in place that has caused financial institutions and other lenders around the globe, including those in Florida, to tighten lending standards to the point where the global, national, and state economies, especially Florida's, are reeling. A vicious cycle has ensued where falling property values have contributed to rising mortgage delinquencies and foreclosures which, in turn, have contributed to mounting losses for financial institutions and other investors. These losses have, in turn, contributed to a lower risk tolerance, tighter lending standards, and less lending which, in turn, has contributed to falling property values and a repeat of the cycle.

Evidence of the cycle can be seen in a recent Mortgage Bankers Association report showing that the delinquency rate for mortgage loans on 1-4 unit residential properties was 6.41% of all loans at the end of the second quarter of 2008, compared to 5.12% for the same period in 2007. The percent of loans in the foreclosure process stood at 2.75% - almost double the 1.40% rate at the end of the second quarter of 2007. According to the Mortgage Bankers Association, these increases were driven by rising delinquencies and foreclosures, which were concentrated in Florida and California. These two states alone accounted for 39% of all net foreclosures started in the second quarter of 2008, and 73% of the increase from the first to the second quarter of 2008.

The Federal Reserve responded promptly to the liquidity drought, although they may have been surprised at how quickly the contagion spread from the CDO market to the broader credit markets. The federal funds interest rate was reduced from 5.25% to its current level of 2.00%, and the lending rate to depository institutions was cut from 6.25% to 2.25%. Moreover, the Federal Reserve expanded its short-term lending facilities, opening them to non-depository financial institutions and enlarging the range of eligible collateral. The Federal Reserve was also an active participant in the sale of Bear Stearns investment bank to JP Morgan - Chase. In all these endeavors, the Federal Reserve appears to have been guided by efforts to control systemic risk and by the dictum of the legendary 19th century economist Walter Bagehot that central banks ought to lend to troubled banks against high quality collateral at a punitive rate. To this point, the Federal Reserve has been successful in reducing systemic risk and providing adequate liquidity to the U.S. economy via the financial sector.

The crisis has now evolved from one of liquidity to one of financial institution capital - exacerbated by the slowdown in the U.S. economy. According to the International Monetary Fund, U.S. financial institutions have incurred about $250 billion in losses since the onset of the financial crisis and have raised about $175 billion in new capital, resulting in a net decline in capital of approximately $75 billion. This loss of capital could normally support roughly $900 billion of loans.

Faced with rising loan losses, weakening balance sheets, and heightened regulatory scrutiny, capital has become the key emphasis of financial institutions. Financial institutions have sought to conserve existing capital and raise new capital. To protect existing capital, financial institutions have contracted their balance sheet risk profiles by reducing risky loans. In other words, lending standards have been tightened considerably. At the same time, raising additional capital has proven especially challenging since investors are understandably hesitant to purchase securities of firms in a troubled sector.

Potential home buyers, as well as home owners seeking re-financing, have thus found mortgage loans to be increasingly scarce. The greater scarcity of mortgage financing has intensified the ongoing plunge in housing prices and deepened the slowdown in the U.S. economy and the recession in the Florida economy.

Breaking this vicious housing price decline - tighter lending standards cycle and downward economic spiral - could prove extremely difficult. Prospective home buyers must sense that housing prices are at a bottom and mortgage lending institutions and investors must restore their capital positions and be willing to assume somewhat greater risk.

As we 'go to press' the U.S. Treasury has announced it is placing Fannie Mae and Freddie Mac under government conservatorship. These two government-sponsored firms provide funding for roughly three-quarters of new home mortgages by purchasing qualified mortgages from originating lending institutions. Fannie Mae and Freddie Mac then bundle these loans for sale to investors and guarantee their performance. Historically, they have raised funds to purchase mortgages at favorable interest rates. Close to $5 trillion of mortgages are on their books. Over the last four quarters they have suffered losses of approximately $14 billion as housing and mortgage markets deteriorated, and the outlook was for even more losses.

Under conservatorship, the federal government, through the Federal Housing Financing Agency, will basically run the operations of Fannie Mae and Freddie Mac. The U.S. Treasury has injected $2 billion of taxpayer equity capital into the two mortgage giants and may provide another $200 billion of capital to restore the firm?s financial health. The costs to taxpayers are uncertain, but future profits will first go to taxpayers.

Over time, this dramatic government intervention may be an important catalyst in thawing the housing finance mortgage markets and the credit markets in general. Given the depth of the housing market collapse and recession in Florida, this recent occurrence could signal, to paraphrase Winston Churchill, "the end of the beginning but not the beginning of the end."

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