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PAGE ONE

Debt Reckoning: U.S. Receives a Margin Call

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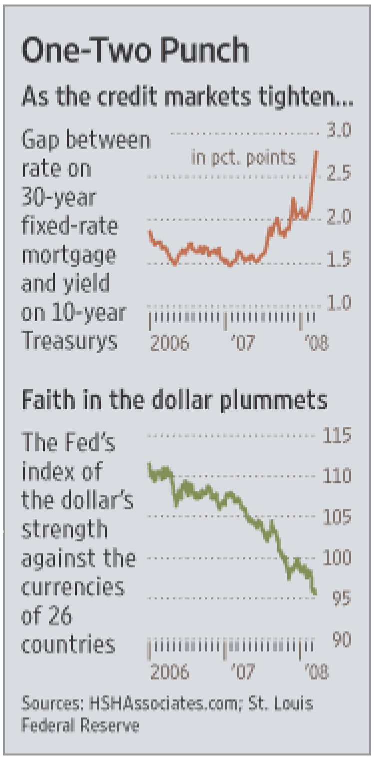
The U.S. is at the receiving end of a massive margin call: Across the economy, wary lenders are demanding that borrowers put up more collateral or sell assets to reduce debts.



The unfolding financial crisis -- one that began with bad bets on securities backed by subprime mortgages, then sparked a tightening of credit between big banks -- appears to be broadening further. For years, the U.S. economy has been borrowing from cash-rich lenders from Asia to the Middle East. American firms and households have enjoyed readily available credit at easy terms, even for risky bets. No longer.

Recent days' cascade of bad news, culminating in yesterday's bailout of **Bear Stearns** Cos., is accelerating the erosion of trust in the longevity of some brand-name U.S. financial institutions. The growing crisis of confidence now extends to the credit-worthiness of borrowers across the spectrum -- touching American homeowners, who are seeing the value of their bedrock asset decline, and raising questions about the capacity of the Federal Reserve and U.S. government to rapidly repair the problems.

Global investors are pulling money from the U.S., steepening the decline of the U.S. dollar and sending it below 100 yen for the first time in a dozen years. Against a trade-weighted basket of major currencies, the dollar has fallen 14.3% over the past year, according to the Federal Reserve. Yesterday it hit another record low against the euro, falling 2.1% this week to close at 1.567 dollars per euro.

Lenders and investors are pushing up the interest rates they demand from financial institutions seen as solid just a few months ago, or demanding that they sell assets and come up with cash. Banks and Wall Street firms are so wary about each other that they're pulling back. Financial markets, anticipating that the Fed will cut rates sharply on Tuesday to try to limit the depth of a possible recession, are questioning the central bank's commitment or ability to keep inflation from accelerating.

There are other symptoms of declining confidence. Gold, the ultimate inflation hedge, is flirting with $1,000 an ounce. Standard & Poor's Ratings Services, a unit of McGraw-Hill Cos., predicted Thursday that large financial institutions still need to write down $135 billion in subprime-related securities, on top of $150 billion in previous write-downs. Ordinary Americans are worried: Only 20% think the country is generally headed in the right direction, nearly as low as at any time in the Bush presidency, according to the latest Wall Street Journal/NBC News poll[1].

"Clearly, the whole world is focused on the financial crisis and the U.S. is really the epicenter of the tension," says Carlos Asilis, chief investment officer at Glovista Investments, an advisory firm based in New Jersey. "As a result, we're seeing capital flow out of the U.S."

That is a troubling prospect for a savings-short, debt-heavy economy that relies on $2 billion a day from abroad to finance investment. It is raising the specter of the long-feared crash in the dollar that could further rattle financial markets and boost U.S. interest rates.

Offsetting the Pain

Though the risks of an unpleasant outcome are worrisome, the effects of Fed interest-rate cuts and fiscal stimulus have yet to be fully felt by the U.S. economy. Moreover, the combination of a weakening dollar -- which remains the world's favorite currency -- and still-growing economies overseas is boosting U.S. exports and offsetting some of the pain of the housing bust and credit crunch.

But while cash continues to pour into the U.S. from abroad, this flow has been slowing. In 2007, foreigners' net acquisition of long-term bonds and stocks in the U.S. was $596 billion, down from $722 billion in 2006, according to Treasury Department data. Americans, meanwhile, are investing more of their own money abroad.

Hopes are fading fast that the U.S. economy was suffering from a thirst for liquidity that standard Fed remedies could quench. Former Treasury Secretary Lawrence Summers, speaking in Washington yesterday, said he sees "an increasing risk that the principal policy tool on which we have relied -- the Federal Reserve lending to banks in one form or another" -- is like "fighting a virus with antibiotics."

Bob Eisenbeis, a former executive vice president of the Federal Reserve Bank of Atlanta, says the problem is more than an inability to find ready buyers for assets. "It is time to step back and recognize that the current situation isn't a liquidity issue and hasn't been for some time now," said Mr. Eisenbeis, the chief monetary economist for Cumberland Advisers. "Rather, there is uncertainty about the underlying quality of assets -- which is a solvency issue, driven by a breakdown in highly leveraged positions."

President Bush, speaking in New York and in a television interview yesterday, showed little appetite for further action. Detailing the steps the administration has already taken, the president in a speech knocked a couple of pending proposals. "Government policy," he said, "is like a person trying to drive a car on a rough patch. If you ever get stuck in a situation like that, you know full well it's important not to overcorrect -- because when you overcorrect you end up in the ditch."

But few in markets and elsewhere are convinced that the worst is over for the U.S., as each player moves to protect its own interests against potential calamities seen as improbable just a few months ago. Bear Stearns reassured investors earlier this week that it was solvent, but speculation that Bear faced a liquidity crunch had some traders and hedge funds moving to limit their exposure to it. Yesterday, **J.P. Morgan Chase** & Co. and the Federal Reserve Bank of New York offered emergency funds to keep the troubled investment bank afloat.

The loss of confidence is now spreading beyond the biggest banks, with their well-publicized losses on subprime and other risky assets, to regional and small banks. In the fourth quarter, U.S. banks reported their smallest net income -- a total of $5.8 billion -- in 16 years, according to the Federal Deposit Insurance Corp.

There's little sign yet that the worst is past. The "moment of recovery" is when forecasters turn out

to be too pessimistic, says Mr. Summers. That point hasn't likely arrived. A Wall Street Journal survey of more than 50 economic forecasters in early March found a profound shift toward pessimism: About 70% say the U.S. is currently in recession, and on average they put the odds that this recession will be worse than the past two mild, short recessions at nearly 50%. Most expect house prices to decline into 2009 or 2010.

This couldn't come at a worse time for U.S. homeowners. American household debt has more than doubled in a decade to $13.8 trillion at the end of 2007 from $6.4 trillion in 1999, the vast majority of it in mortgages and home equity lines, according to Fed data. But the value of U.S. householders' biggest asset -- their homes -- is now falling.

Federal Response

The response of the Republican White House, Democratic Congress and Federal Reserve have been substantial. President Bush and Congress, with remarkable speed, agreed to a $160 billion fiscal-stimulus package that will put money in consumers' wallets soon. The Fed already has cut interest rates by 1 1/4 percentage points this year, and markets anticipate another 3/4 point cut on Tuesday. The Fed has moved to buy $400 billion worth of mortgage-backed securities for its $800 billion total securities portfolio in an effort to jolt that crucial market back to life and prevent rising mortgage rates from further depressing the U.S. housing market.

While there is continued debate about how to treat the current disease, there is a consensus emerging on the causes. "Soaring delinquencies on U.S. subprime mortgages were the primary trigger," the heads of the Treasury, Federal Reserve and Securities and Exchange Commission said in a lessons-learned report. "However, that initial shock both uncovered and exacerbated other weaknesses in the global financial system."

Kenneth Rogoff, a Harvard University economist, says the current difficulty has many mothers -- the housing bubble, the subprime problem and the fact that the value of U.S. imports has long outstripped the value of exports. The current account deficit -- the broadest measure of the trade deficit -- burgeoned, and the U.S. needed to borrow ever larger amounts of cash from abroad to fund it.

For years, Mr. Rogoff and like-minded economists harped that the U.S. current account deficit was unsustainable. But despite the belief that it would necessarily reverse, it kept growing through the first part of this decade, going from 3.6% of gross domestic product at the end of 1999 to a record 6.8% at the end of 2005. Lately, the deficit has seen a slight narrowing, but the combination of credit crisis and the economic downturn may have proved the catalyst for a faster, and potentially more dangerous, adjustment.

Pressures in one market spread rapidly to other, often more distant markets. "The dollar and subprime -- they're two sides of the same coin," says Princeton University economist Hyun Song Shin. Many U.S. hedge funds and financial institutions were speculating in mortgage-related securities with money that was ultimately borrowed in Japan, where interest rates have been low for years. He notes foreign banks' net liabilities in the yen interbank market surged between April 2006 and April 2007. As investments bought with money borrowed in Japan get sold and converted back into yen, he says, "we see both a fall in asset prices and a fall in the dollar."

Crossing a Line

The resulting blow to confidence threatens to further weaken lending, borrowing, spending and investment in the U.S. economy. "Hedge fund blowups have so far been one-off situations. One worry is that we'll cross some line and there'll be a systemic wave of fund failures. It's a reason why the market is so nervous," says John Tierney, credit derivatives strategist at Deutsche Bank.

Banks also are increasing the collateral they demand when they lend to hedge funds that hold municipal bonds. One hedge fund manager described what appears to be a coordinated effort by big investment banks to reduce their risk as they faced quarter-end pressures to cleanse their balance sheets. Lenders declared "by fiat," he said, that municipal-bond-fund managers needed to post more collateral to back their borrowings.

As a result, funds run by Blue River Asset Management, 1861 Capital Management and others circulated lists of assets to raise cash. The sell-off flooded the market with municipal bonds, making it more expensive for municipalities to borrow and upending the traditional relationship between tax-exempt municipal bonds and taxable U.S. Treasury bonds. For the first time in memory, yields on tax-exempt municipal bonds jumped above yields on taxable U.S. Treasury debt.

Now, many hedge fund managers say, access to borrowed money, essential for many of their investment strategies to work, has become virtually impossible.

Mohamed El-Erian, co-chief executive officer of Allianz SE's Pacific Investment Management Co., says the hedge-fund community is unwinding its leverage. "This will push more of them into 'survival mode,' further accentuating distressed sales and nervousness among the prime brokers," he wrote to his colleagues Thursday morning. "In such a world, the quality of the assets matters less than whether you can finance them [or] how liquid they are."

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