



THE HAMPTON ROADS ECONOMIC QUARTERLY

Paul D. Fraim, Chair • Dwight L. Farmer, Executive Director/Secretary • John M. Carlock, Deputy Executive Director

Volume 1, Number 1 • Fall 2008

HRPDC Economics Staff

Greg G. Grootendorst
Chief Economist

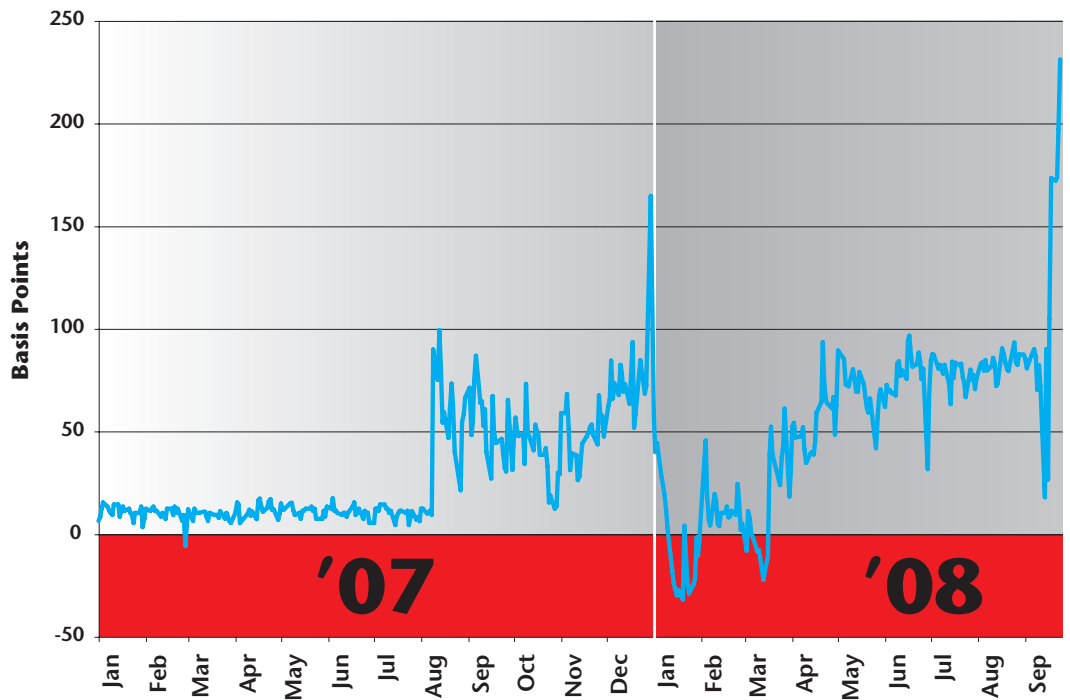
James A. Clary
Economist

The Frozen Credit Market

The worldwide credit markets have been seizing up gradually over the past eighteen months, but the situation has become increasingly worse since the bankruptcy of Lehman Brothers. As financial institutions have been unable to borrow from one another, many have been forced to undergo reorganizations and takeovers as demands on previously authorized lines of credit and runs on deposits have left these banks significantly under capitalized. President Bush recently signed a \$700 billion rescue plan into law, but there remains significant confusion as to the relationship between the financial markets and the local economy.

Financial institutions entered the crisis because they were highly leveraged and a large portion of their capital comes from the housing market, which is currently undergoing a national correction. The correction would have put stress on a well capitalized financial system, but as a result of new investment vehicles, many national banks were exposed to the real estate market to an even greater extent than they were historically. Mortgage Backed Securities (MBS) allowed a bank to limit its exposure to regional downturns in the housing market by selling individuals mortgages made locally to investment banks that would repackage a mortgage with many others of similar quality from around the nation. Investment banks would then sell claims on the income generated by these mortgages back to local banks as an

Spread Between 3-Month LIBOR and Effective Fed Funds Rate



Source: British Bankers Association, Federal Reserve

The London Interbank Offered Rate (LIBOR) measures the interest rate that banks offer to lend unsecured funds to one another. The Effective Fed Funds Rate is the cost of overnight lending from one bank to another, but is often near the target established by the Federal Reserve. The difference between the two rates (the spread) is the clearest indication of perceived default risk in the financial markets.

MBS. Since these securities were backed by mortgages from around the country, a fall in one housing market would not cripple the cash flow of that market's banks (similar logic applies to banks accumulating equity and bonds from Fannie and Freddie). An additional benefit of swapping mortgages for MBS and government sponsored entities (GSE) bonds is that banks could now count the MBSs and GSEs as capital, allowing banks to make additional loans and further extend themselves. The housing correction overwhelmed the MBSs and GSEs because of its large and widespread impact on real estate prices.

Banks are holding high levels of MBSs, and these securities are missing dividends because a number of homeowners are not making mortgage payments. The declining stream of income and the myriad of mortgages which back these securities have made them more difficult to value. Additionally, these securities are incurring higher administration costs due to foreclosures on homes in their portfolios, many of which will not fetch the value of their initial mortgage when they are resold. The difficulty in valuing these MBSs has resulted in limited liquidity, and a free fall in the market price of these securities, forcing some banks to sell them for pennies on the dollar.

While many banks are capital constrained by their investments in MBSs, they are also unable to use their current capital effectively because of the breakdown in the interbank credit market. In a healthy credit market, banks have all but their 10% reserve requirements issued out as loans to the market, and when they experience an unusually large draw down in demand deposits they obtain loans from other banks; this is not currently the case. The cost of loaning to banks on all but the shortest timelines has become increasingly expensive. This is demonstrated by the rapid increase in the spread between the overnight and 3-month interbank (see chart) rate since the collapse of Lehman Brothers.

Most purchases are financed through some credit vehicle including car loans, credit cards, and home loans; this also includes investments such as small business purchases and college education. Banks typically finance these loans through deposits, borrowing from other banks and through securitization of their loan portfolios (selling loans to outside investors). The only avenue available in the current business climate are demand deposits, but because of the inability of banks to obtain short term loans from other banks, these demand deposits do not have the velocity (and thus cannot support as many loans) as they would during a normal economy, resulting in a severely curtailed ability to lend.

This raises questions about the impact of the financial crises on Hampton Roads.

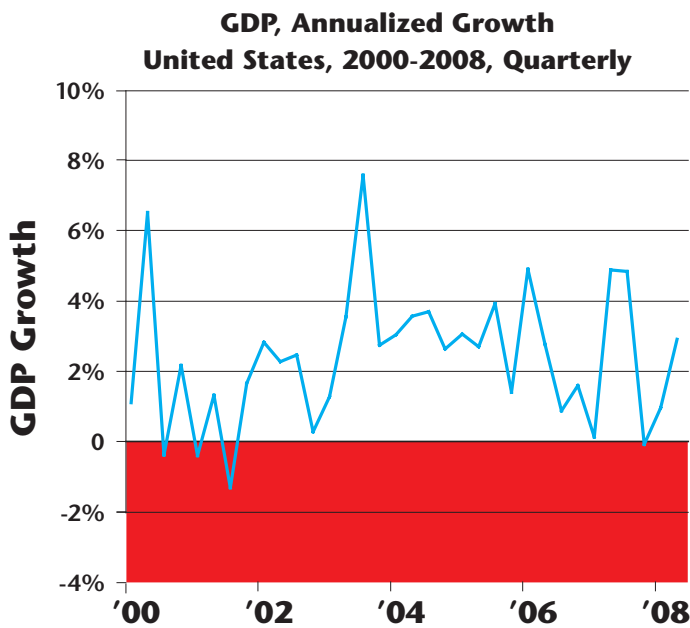
While financial services account for a small percentage of the region's employment, significant impact will be realized by those who rely on access to credit. This is especially true for the local housing market which heavily relies on access to mortgage loans. While home prices have held steady in Hampton Roads, the housing market has slowed significantly, putting constant pressure on the market. The lack of new home loans, along with a climate of economic uncertainty, has led to 30% declines in car sales for domestic car producers; this has led to reports that as many as one in five car dealerships could close doors (forecast by Grant Thornton LLP). This also threatens the health of local universities, especially private universities where students need loans to bridge the gap between financial aid and tuition. Lastly, it will be extremely difficult to start a small/local business as most small business owners rely on credit for initial expenses and to develop operating capital. The creation of small businesses is a key driver of local economies. Fortunately, several of Hampton Roads community banks have been successful in raising capital (Gateway is replenishing its capital before its merger with the Bank of Hampton Roads, and Townebank raised capital in its recent sale of preferred stock). This will ease the local impact of national credit problems as exemplified by Wachovia.

An element particular to local governments has been a weaker market for Government issued bonds. The weak market has resulted in localities paying a much higher debt burden for projects (New York City most recently), or failing to have access to the market at any price. This will be a consideration for government infrastructure projects.

Economic Outlook in Hampton Roads

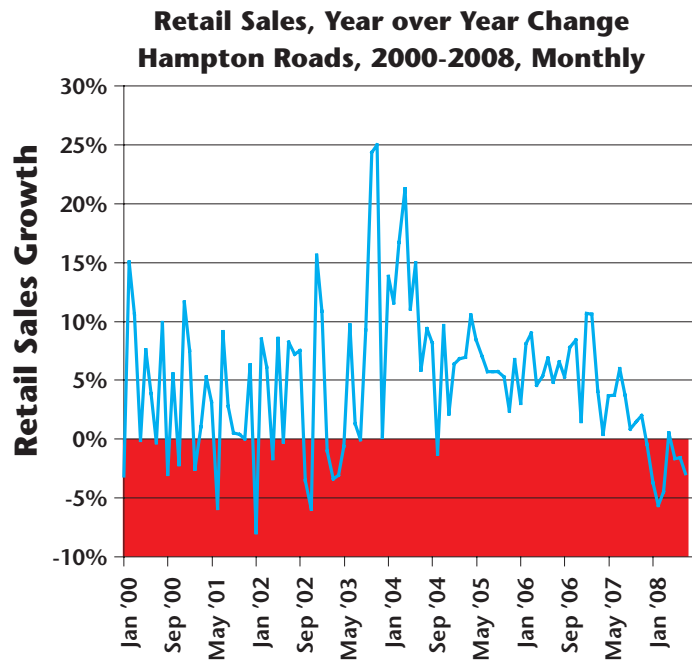
The regional economy continues to face many of the difficulties created by national conditions. One of the primary symptoms is the declining retail sales that Hampton Roads has experienced over the past eight months. This was partly driven by flat growth in the tourism industry, but also from weak consumer confidence and concerns about the future. The unemployment rate has increased to 4.97%, despite continuing growth in employment, a result of a growing Hampton Roads Labor Force. Initial unemployment claims in the region have held steady, indicating that the region currently is not suffering from major labor market dislocations. Continuing a national trend, Hampton Roads continued to add employment to the fields of healthcare, education, and professional business services, while experiencing declines in the manufacture of durable goods.

The fact that single family permits continue to decline is indicative of the reaction that regional builders have had to the current issues in the housing market. This will allow Hampton Roads housing market to move back toward equilibrium; unfortunately, those who are either employed in the local construction industry or who supply the construction industry will continue to feel pressure.



Source: Bureau of Labor Statistics

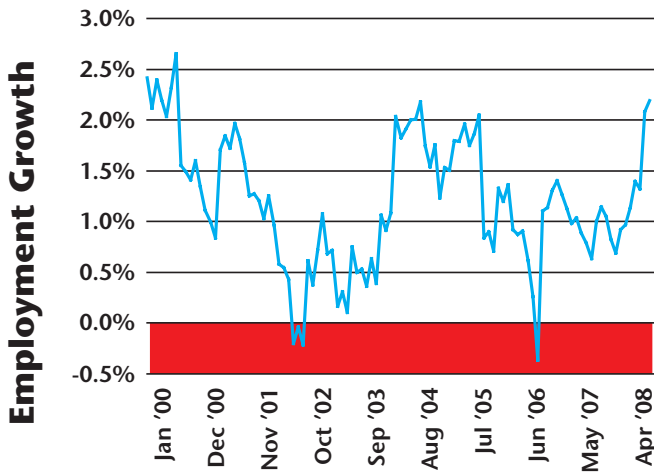
GDP: Gross Domestic Product combines consumption, investment, net-exports, and government spending to determine the size and general health of the economy. Changes in the nation's GDP tend to be reflected in Hampton Roads' gross regional product



Source: Virginia Department of Taxation

Retail Sales: The region has seen retail sales decline against sales from the previous year since last December. There is a brief respite corresponding with tax rebates and stimulus checks, but the effects of those have since subsided.

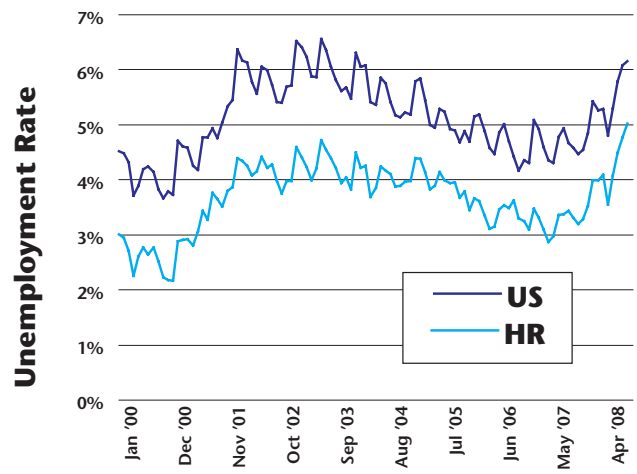
Employment, Year over Year Growth Hampton Roads, 2000-2008, Monthly



Source: Bureau of Labor Statistics

Employment: Non-agricultural employment in Hampton Roads continues to climb, showing the resilience of the regional economy. These employment numbers do not include those directly employed by the military.

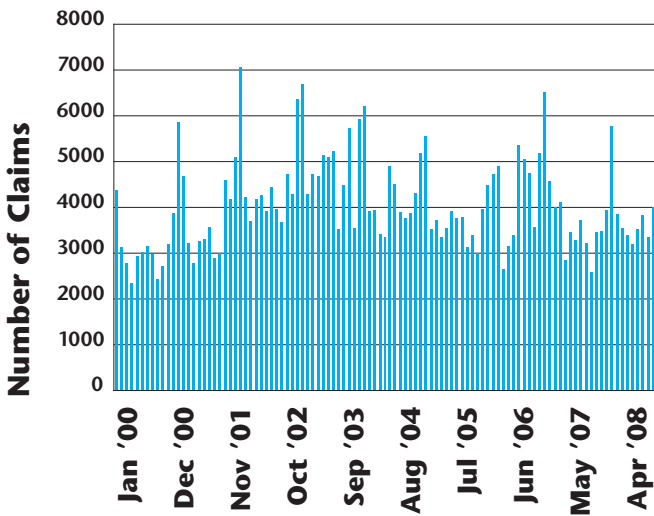
Unemployment Rate U.S. & Hampton Roads, 2000-2008, Monthly



Source: Bureau of Labor Statistics

Unemployment Rate: This is the percentage of the population who are actively seeking but are unable to obtain work. Note Hampton Roads has a significantly lower unemployment rate than the nation.

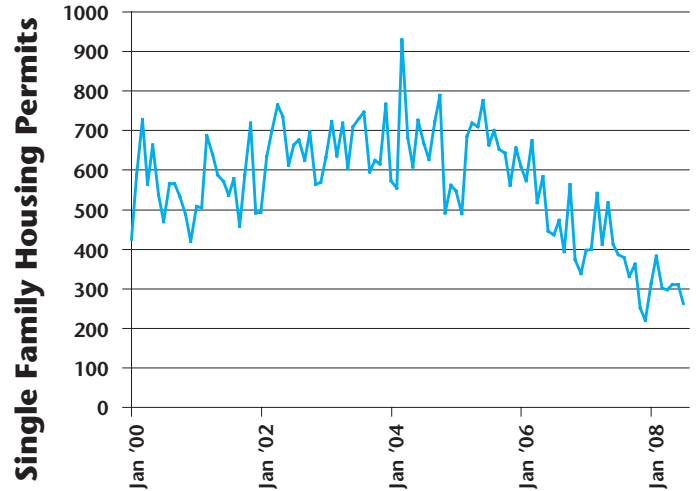
Initial Unemployment Claims Hampton Roads, 2000-2008, Monthly



Source: Department of Labor

Initial Unemployment: The number of initial unemployment claims is a leading economic indicator, reflecting those who are forced to leave work unexpectedly and thus revealing the strength of the job market with little lag time. The pattern of change is more important than any individual data point, and while there have been fluctuations in the region's jobless claims, there has been no sustained trend of weakness in Hampton Roads.

Single Unit Housing Permits Hampton Roads, 2000-2008, Monthly



Source: U.S. Census Bureau

Housing Permits: The total number of housing permits issued in the Hampton Roads MSA continues to fall from its peak in 2003. While this signals a slowdown in regional economic activity, this is a necessary step toward bringing the market back toward equilibrium.