False Profits

Recovering from the Bubble Economy

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ONE

Economic Collapse: It *Is* Their Fault

Imagine if the economy were managed by people who did not know basic arithmetic, the stuff that we all learned in third grade. Imagine further that as a result of their inability to understand simple arithmetic, huge economic imbalances grew to ever more dangerous levels.

If this happened, surely the business and economics reporters would be on the job, pointing out the ungodly incompetence of the country's top economic officials and the risks that their ignorance posed for us all. Undoubtedly, thousands of economists, all quite skilled at mathematics, would be pointing out the errors. Members of Congress, especially those sitting on the committees that have major economic responsibilities, would be organizing hearings to call attention to the mismanagement of the economy.

If the media, the economics profession, and Congress somehow failed to move quickly enough, and disaster struck, certainly those most responsible for this calamity would lose their jobs and suffer public humiliation. Lengthy news stories would denounce problems in our system of governance that allowed for extraordinary incompetence at the highest levels.

Not in America.

The basic story of the economic crisis is that the top economic leaders acted as though they were ignorant of third-grade arithmetic. The fact is, they are not—these are intelligent people—but they ignored enormous imbalances in the U.S. economy that could have been easily detected with nothing more than a third-grade education and common sense. Specifically, they ignored the growth of a housing bubble that eventually expanded to more than $8 trillion. They also ignored the inevitability that this bubble would collapse and devastate the economy.

One can speculate about the reasons our economic leaders ignored this massive threat to the well-being of the economy and the country as a whole. For a while, everything seemed fine, as long as the growth of the bubble expanded the economy and created jobs. In addition, politically well-connected people in the financial sector were making enormous fortunes. Those responsible for managing the economy had real incentives to ignore a looming crisis, even if it was completely apparent to them.

Where were the business and economic reporters? They generally show extraordinary deference to the Federal Reserve

Board (Fed) chairman, the Treasury secretary, and other top economic officials. In fact, in the late 1990s, a prominent *Washington Post* reporter wrote a glowing account of Alan Greenspan's management of the economy titled "Maestro." Few reporters are confident enough about their own analytic abilities to directly confront top officials and suggest that they are fundamentally mismanaging the economy. After all, the Fed chairman, Treasury secretary, and the rest are very smart people; otherwise they would not hold these positions.

What about the thousands of independent economists? Surely they would have sufficient confidence in their analytic abilities to raise the alarm. Simple economic analysis suggests that they are unlikely to speak up against a consensus in the profession. But even a confident and smart economist cannot be certain that she is right. After all, we all make mistakes. If Alan Greenspan says that black is white, he could be right.

Questioning the status quo becomes even more intimidating when everyone else seems to agree. When Alan Greenspan says no housing bubble exists, and all the other big-name economists more or less concur, then maybe black is white. A young economist seeking tenure, or even a more established economist looking to move up the profession's ranks, would be taking a great risk by warning about the housing bubble. The price of being wrong would be ridicule and the likely end of any hopes of career advancement. Sticking with the mainstream of the profession would be far safer.

The incentives for conformity created by the sociology of the economics profession run deep. Robert Shiller, a Yale

economics professor and one of world's preeminent financial economists, began warning of the housing bubble in 2003. However, even he noted how constrained he felt he needed to be in his warnings.[1] Shiller didn't want to be rude in pushing his view, in spite of the fact that he knew that failure to contain the bubble could lead to the sort of economic disaster that we are now experiencing.

When those within the core of the profession are constrained from raising the alarm by the positions they hold, the job is left to those at the margin. And those at the margin are, by definition, marginalized. So, if Alan Greenspan says that everything is fine, the public should not be concerned if a few economists at the margin of the profession are pointing to the storm clouds on the horizon.

As far as the hope that our representatives in Congress would raise the alarm—let's just state the obvious: politicians are rarely leaders. The most effective politicians detect changes in public sentiment and respond to them quickly. They don't get out in front and warn the public of new problems that are not yet widely recognized. Very few politicians—certainly none in leadership positions—would challenge the consensus within the economics profession.

The ignorance of those who should have known better was abetted by the fortune that the financial industry was making off the housing bubble. Top executives in the industry were offering substantial rewards to their friends in academia and politics who went along for the ride. The truth plus 50 cents may buy a cup of coffee, but most of those who could have

blown the whistle were looking for something more. The top executives of Citigroup, Lehman Brothers, Bear Stearns, and other financial institutions central in providing the financing that propped up the bubble had no interest in bringing the party to an early end.

What about after the fact? Once the bubble burst and the damage had been done, we would expect the people who failed at their jobs to be held accountable. Maybe somewhere, but not in this country. The basic story is that the people who failed to warn of the housing bubble are the people in charge of repairing the damage.

The people reporting on finance today are for the most part the same people who ignored the bubble in the years 2002–2007. They have little interest in admitting how easy it was to both recognize the bubble and predict the resulting damage from its collapse. The economists who either didn't see the bubble, or didn't want to stick their necks out by discussing it, are the same ones charting the economic path going forward. They don't want to call attention to the difficulties they seemed to have with third-grade arithmetic. And the politicians are still listening to the bankers, who still have lots of money for campaign contributions.

So, instead of inquests and exposes, we get cover-ups. Almost all discussions about how we failed to see catastrophe coming focus on the financial aspects of the crisis, many of which are complicated, and ignore the fundamental cause: the huge overvaluation of the country's housing stock. Once the topic moves from bubble-inflated house prices to credit default

swaps and collateralized debt obligations, nearly everyone following the news is safely lost.

In this financial crisis story, the crisis is talked about as if it were a rare and highly unlikely event—a black swan—rather than one that could be predicted with absolute certainty, even if the timing and exact course of events could not be known.[2] Instead of firing all the people who didn't do their jobs, Washington's policy elite has instead focused on creating a new agency—a "systemic risk regulator"—responsible for detecting such "unlikely" events in the future.

The "systemic risk regulator" is the ultimate joke on the country. We already have a systemic risk regulator. It's called the Federal Reserve Board. At many points it has staged extraordinary interventions whenever it felt that events in the financial sector were spinning out of control and threatening to seriously harm the economy. Alan Greenspan's efforts to shore up the stock market after the 1987 crash and his intervention in the unraveling of the Long-Term Capital Hedge Fund in 1998 provide the two most obvious examples.

The problem was not that we lacked a systemic risk regulator but rather that we had one that failed catastrophically at its job. Rather than holding our failed regulators accountable, we are pretending that their job descriptions were the problem. This response is akin to creating a new government agency to rescue people from burning buildings after an especially deadly fire. The more obvious solution is to dump the head of the fire department.

The assumption would be that if people died in burning

buildings, it was because the fire department hadn't done its job. When the economy suffers a collapse like the housing crash recession, failed economic management is the culprit. The way to improve economic management is to hold the managers accountable for their performance, thereby giving them an incentive to buck the consensus opinion and say what they believe to be correct. Covering up failure is a recipe for more failure.

Regulators and others in policy positions certainly face risks by stepping out of line. But these people must come to know that they face comparable risks by not stepping out of line when the situation demands it. In other words, if we want good policy, we must let those in policy positions know that they will be fired if they don't warn us about an enormous housing bubble.

Those who ignored the housing bubble messed up horribly and should be fired. Instead, it appears that they will escape virtually any sanction. Left in place, they will do more damage and set the worst possible example for regulators and policymakers in the future.

The Story of the Housing Bubble

The basic story of the housing bubble and its collapse is simple. For 100 years, from 1895 to 1995, nationwide house prices in the United States tracked the overall rate of inflation. This trend meant that, on average, house prices rose at the same rate as the price of other goods: food, cars, clothes, and so on.

Differences in the rate of price increases among geographic areas were large. House prices in places like the New York suburbs or San Francisco did rise far more rapidly than the overall rate of inflation. But rapid price increases in these areas were offset by prices that trailed the rate of inflation in areas like Gary, Indiana, or St. Louis, Missouri. These areas of falling house prices were large enough to keep nationwide house prices just even with the overall rate of inflation.

Some price variation by year was also common. During some years, house prices did rise more rapidly than the overall rate of inflation, sometimes for four or five years in a row. But even in these cases, the cumulative increase in house prices was only slightly greater than the rate of inflation, in the range of 10 to 15 percentage points. Eventually these run-ups would be offset by house prices that rose less rapidly than other prices.

A 100-year trend is an extremely long trend in economics. Over this same period, the U.S. economy experienced huge changes, including the massive immigration wave at the beginning of the 20th century, two major wars, and the Great Depression. A trend that persists through all these changes, especially one that occurs in the largest market in the world, should be taken seriously. Prices in smaller markets, for example, the market for a mineral like gypsum or quartz, may be subject to erratic forces that lead them to fluctuate in unusual patterns. But the housing market in the United States was a $10 trillion market in 1995, even before the bubble sent prices through the roof.

In short, given the enormous size of the market and the history of house prices, economists had good reason to take notice when, in 1995, those prices began to outstrip the overall rate of inflation. When I first wrote about the housing bubble in the summer of 2002, house prices had already outpaced the overall rate of inflation by 30 percent, creating more than $3 trillion of housing-bubble wealth.[3] Even by that point it should have been evident that the housing market was in a seriously expanding bubble. Absolutely nothing on either the demand or the supply side of the market—that is, in the fundamentals of the market—could have explained this unprecedented increase in nationwide house prices.

On the demand side, the two main factors are income and population. If income grows rapidly, people may want bigger and better homes, or even second homes. Other things being equal, a more rapidly increasing population will lead to more rapid growth in the demand for housing, especially if the growth rate is high among people in their 20s, who are forming their own households for the first time.

Neither of these factors offers an explanation for the run-up in house prices during this period. Income growth had been healthy during the late 1990s, but it was not extraordinary. The rate of growth of median family income over the four years from 1996 to 2000 was no more rapid than the growth rate over the long boom from 1947 to 1973. Yet, in that era, house prices did not even keep pace with inflation. Furthermore, the country had fallen into a recession in 2001, and family income had begun to decrease. Income growth

remained weak right through the rest of the bubble period, even though some modest gains occurred in 2005 and 2006. Income growth alone could not explain the extraordinary increase in house prices during this period.

Population growth is an even less plausible explanation. Although Alan Greenspan once cited immigration as a factor pushing up prices, the reality is that the inflow of immigrants in the 1990s and the following decade was a relatively minor phenomenon compared with the demographic bulge created by the baby-boom cohort. (In addition, not many immigrant families would have been able to afford the $400,000 homes that were standard in bubble markets like Los Angeles, San Francisco, and Washington DC.) The rate of household formation was far more rapid in the 1970s and early 1980s, when the baby boomers were first forming their own households, than in the bubble years.

By the mid-1990s, the overwhelming majority of the baby boomers who would ever be homeowners already owned a home. These families were watching their children finish school and leave home. By the end of the housing bubble, the oldest baby boomers were already in their 60s. If anything, the baby boomers would be looking to move into smaller homes. A population-driven increase in the demand for homes could not explain the extraordinary run-up in house prices either.

Economists should have been well aware of the country's demographics; the future of Social Security was one of the main topics of economic policy debates throughout this

period. The main (and not very accurate) story line for the Social Security "crisis" was that the program would soon be overwhelmed by the retirement of the baby-boom cohort, which would lead to a large increase in the ratio of retirees to workers, resulting in benefit payments vastly exceeding tax revenue.

The real story of Social Security was less frightening than the claims of those who wanted to privatize the program; but the basic fact that the ratio of retirees to workers was rising should have immediately told any economist that attributing the run-up in house prices to demographics was nonsense.

Neither income growth nor population growth, the two main factors on the demand side, could explain the run-up. The supply side of the market offered no better explanations. Alan Greenspan once suggested that environmental constraints on building were one cause of the run-up in house prices. This explanation should have immediately prompted derision.

Despite certain environmental restrictions on building during the era of the housing bubble, that era was hardly the high point of the environmental movement. The Republican takeover of Congress in 1994 would have constrained any environmentalist excesses at the national level. Moreover, the Republican takeover of many state legislatures and governorships in the same election would have curbed environmentalist drives at the state level as well. The belief that environmental restrictions were imposing more constraints

on the supply of housing in this period than in prior decades had no basis.

Greenspan also suggested that the limited supply of buildable land in desirable urban areas was a factor pushing up house prices. Land in urban areas is limited, but this reality was not new to the mid-1990s. This constraint had not led to a run-up in house prices over the prior hundred years, so why it would have made these prices suddenly rise nationwide in 1995 is difficult to fathom.

Attributing a rapid rise in house prices to the limited supply of land in the heyday of the Internet era and the "new economy," when limits of time and space supposedly no longer applied, is somewhat ironic. Although most of the new economy hype was nonsense, the Internet did sideline those limits by making telecommuting possible. As a result of the Internet, many people can live at great distances from their workplace, commuting into work only rarely, if ever. Telecommuting jobs might represent a small portion of the total jobs in the economy; nonetheless, they would *relax* the time and space limits that might otherwise put upward pressure on house prices.

The easiest way to assess whether supply constraints were causing increases in house prices is to examine the rate of housing construction during this period. The evidence here is straightforward. We were building houses at a rapid pace in the 1990s and at an even more rapid pace in the first decade of the 21st century. In fact, the country was building new housing units at a record rate from 2002 to 2006, when starts averaged

1,880,000 a year. This rate was slightly above the previous five-year peak rate of 1,870,000 from 1969 to 1973, when those on the leading edge of the baby-boom generation were first forming their own households, and the post-war economic boom was still in high gear. Supply constraints could not explain the run-up in house prices.

Economists who still remained unconvinced that house prices were rising due to a bubble rather than to the fundamental factors of supply and demand could have examined the rental market. House sale prices and rents tend to move in the same general direction, although not necessarily at the same pace. Fundamental factors pushing up the sale price of houses should be pushing up rental prices as well.

The story of rental prices during the bubble years is simple: there was no story. Rental prices outpaced inflation by a small amount in the late 1990s, but in the following decade they kept even with the overall rate of inflation or even trailed it slightly. This trend was further evidence that fundamentals, the supply and demand factors, were not driving rapid increases in house prices.

Economists should have considered one final factor: vacancy rates. These data reflect the underlying supply and demand for homes by showing the percentage of the housing stock that is actually occupied. If the enormous run-up in house prices were explained by demand hugely outpacing supply, the vacancy rate should have been very low, as empty houses would be quickly filled. In fact, the vacancy rate was hitting record highs as early as 2002.

The rise in vacancies was showing up primarily on the rental side of the market: in the first quarter of 2002, the rental vacancies rate first surpassed its prior post–World War II peak at 9.1 percent. The rate continued to rise until the first quarter of 2004, when it hit 10.4 percent. Although the vacancy rate for ownership units did not rise substantially until the fourth quarter of 2006 (when it rose to more than 50 percent higher than the previous peak), the record vacancy rate for rental units should have clearly indicated an excess supply of housing.

Vacant units in the rental market would eventually push rents lower. With rents falling relative to sale prices, people would opt to rent rather than buy, eventually putting downward pressure on sale prices. Although only a few people might sell their homes to take advantage of cheap rents, families moving into an area or young people leaving home would base the decision to buy or rent, in part, on the relative cost. When rents are low, such people will put off buying until the prices of owning versus renting are more in line.

The same pattern holds true on the supply side of the market. If landlords are unable to rent their properties or can only get a low rent in a market with high sale prices, they will convert apartments into condominiums. Although this process takes time and can be costly, landlords will find ways to sell if the price differences are large enough.

In short, the record rental-vacancy rate during this period should have been yet another warning sign to economists that the housing market was in a bubble and not being driven by

fundamentals. An enormous oversupply of available housing would eventually drag down prices.

Many economists, including Alan Greenspan, also tried to explain away the bubble by saying that the extraordinarily low interest rates of the period justified the high house prices. In fact, the National Association of Realtors regularly published a "housing affordability index," which compared the cost of servicing a mortgage on the median house with the median family income. This index made the argument that houses were still relatively affordable due to the extraordinarily low mortgage-interest rates, even as house prices were already way out of line with their long-term trend.

The problem with this argument is that virtually no one expected interest rates to remain at these extraordinarily low levels. During the years of unusually low rates, nearly all public and private forecasters were projecting that mortgage rates would soon return to more normal levels. The interest rate on 30-year fixed-rate mortgages bottomed out at just under 5.3 percent in June 2003. Most forecasters projected that the rate would soon rise back to the 6.5 to 7.0 percent range, which would be consistent with a healthy economy and modest inflation.

Historically, house prices had not been that sensitive to interest rates. In prior decades, house prices did not plummet when interest rates rose, nor did they soar when they fell. If Greenspan and others believed that low interest rates in the 2002 to 2003 period explained high house prices, they should

have expected house prices to plummet when interest rates returned to more normal levels.

In short, this inverse correlation between interest rates and house prices was consistent with the existence of a housing bubble. Those who really believed that low interest rates explained the run-up in house prices should have been terrified of the inevitable plunge in house prices when interest rates returned to normal levels. They should have expected the loss of trillions of dollars of housing equity and a situation in which millions of homeowners would suddenly owe more than the value of their homes.

The Spread of Bad Mortgages

As house prices rose to levels that were increasingly out of line with the fundamentals of the housing market—including family incomes, which were not rising—fewer families could afford to buy homes. Nonetheless, home sales and homeownership rates were hitting record levels, thanks to the collapse of lending standards and the spread of subprime and Alt-A mortgages. The explosion in these nonprime mortgages should have been yet another very clear warning signal of a serious housing bubble.

Subprime mortgages carry substantially higher interest rates than prime mortgages, typically about 2 percentage points higher, but sometimes as much as 4. People who get subprime mortgages typically have poor credit records due to past defaults or irregular work histories, making them

unable to qualify for prime mortgages.[4] Through the 1990s and the beginning of the following decade, subprime loans constituted 6 to 8 percent of the mortgage market. The share of subprime mortgages exploded to 25 percent by 2006. This sudden increase should have caught the eyes of regulators.

The growth in Alt-A loans was even more suspicious. Alt-A loans are typically given to borrowers who have good credit records but cannot fully document their income or assets. Alt-A borrowers are often small-business owners, who often see substantial year-to-year fluctuations in their income. In addition, Alt-A borrowers may not be able to fully document their income because they don't fully report it, to avoid paying taxes. Prior to 2002, the Alt-A market constituted between 1 and 2 percent of the mortgage market. This share jumped to 15 percent by 2006. Such an increase should have been even more alarming than the growth in subprime borrowing; such an extraordinary increase in the number of borrowers with incomplete documentation for their loans should have been investigated.

The number of small businesses started during these years did not increase greatly. Because Alt-A mortgages typically charge interest rates that are one to two percentage points higher than prime mortgages, borrowers would have a substantial incentive to dig up old tax forms if they were, indeed, honestly reporting their income. On a $400,000 mortgage (many Alt-A loans were used to buy fairly expensive homes in bubble markets), this documentation could save the borrower $4,000 to $8,000 *a year* in interest. The most obvious

explanation for the increase in Alt-A mortgages during this period was that more people were lying about their income on mortgage applications, an increase that should have led to real concerns about the stability of the housing market.

To make matters worse, the vast majority of the subprime mortgages issued were adjustable-rate mortgages (ARMs), mortgages with interest rates that could be expected to rise in the future. The standard subprime mortgage was a "2-28," in which the interest rate was fixed at a relatively low rate for the first two years, and reset to a higher level in subsequent years, based on market rates at the time. Often the reset rate was four percentage points or more above the initial low "teaser" rate.

The Alt-A loans issued during this period were also typically ARMs, though these mortgages often had low rates for the first four to five years of the mortgage. Toward the end of the bubble, lenders frequently issued "interest-only" mortgages, which allowed borrowers to pay only interest for this initial period. Borrowers would only have to start paying down the principle after the reset date. Banks also developed "option ARMs," which allowed borrowers to vary the amount of their monthly payment during the initial period. These loans generally did not even require that the payment cover the monthly interest on the mortgage. These "negative amortization" loans effectively allowed the size of the mortgage to grow each month, and the borrower didn't have to start paying down the mortgage until after the reset date.

All of these loans were, in effect, time bombs. Millions of

subprime and Alt-A borrowers could afford the initial teaser rates but could not possibly afford the reset rates that kicked in after the initial period. Remarkably, banks issued loans based only on the ability of borrowers to afford the teaser rate.

Banks paid little attention to their borrowers' ability to repay loans because bank policy was usually to resell the loans in the secondary market almost as soon as they were issued. The secondary market exploded as Wall Street banks began to displace Fannie Mae and Freddie Mac as issuers of mortgage-backed securities. (Fannie Mae and Freddie Mac are government-created companies established to promote a secondary mortgage market by buying mortgages from the banks who issued them. Both were largely run as private companies prior to the crisis and continued to fill this public purpose; for this reason, they were subjected to special oversight.) Even though Fannie and Freddie had maintained reasonably strict standards on loan quality, private issuers of mortgage-backed securities—like Merrill Lynch and Citigroup—were prepared to package almost any mortgage into a mortgage-backed security.

A brief digression here may help dispel a couple of myths about the cause of junk loans made during this period. Any conjecture that political pressure to help minorities and low-income families become homeowners was the reason Fannie Mae and Freddie Mac entered the non-prime market is completely untrue. This is completely untrue. Fannie and Freddie did eventually relax their standards and get into the nonprime market, but they were motivated to do so by the need to preserve market share.

Fannie and Freddie began entering the nonprime market in 2005, after losing almost half of their market share to private issuers of mortgage-backed securities. Their decision to enter this market was a response to competitive pressures from the investment banks, not from liberal politicians wanting to help the disadvantaged become homeowners. In fact, no one in a position of political power could have applied such pressure. President Bush was in the White House, and the Republicans controlled Congress until January of 2007, at which point almost all the bad loans had already gone out the door.

The other myth that requires debunking is that banks issued junk mortgages because of pressure to comply with the Community Reinvestment Act (CRA). This myth is unfounded no matter how you look at it. The CRA requires that deposit-taking institutions invest in the communities from which they take deposits. Many of the biggest subprime lenders were not even covered by the CRA; they were mortgage banks that raised their money selling bonds on Wall Street. Furthermore, many of the subprime loans would not even have filled CRA requirements; they were, instead, supporting the construction of new developments in exurbs, not the inner city areas that were the target communities for the CRA.

In short, the CRA had almost nothing to do with the explosion of subprime and Alt-A loans during this period. The banks issued these loans *only* because they could be profitably sold in the secondary markets. The investment banks eagerly

gobbled up any loans the banks could issue. The investment banks considered themselves masters at containing risk and developed complex instruments such as collateralized debt obligations, which were supposed to allow them to spread risk more widely. These assets, in turn, were blessed as investment grade by the credit rating agencies, who happened to be paid by the banks whose assets they were rating.

This system worked fine as long as the bubble continued to expand, because borrowers facing trouble paying their mortgages could always refinance. And, in fact, many homeowners refinanced multiple times during the bubble. If a mortgage became unaffordable, it was a simple matter of taking out a new mortgage with a new two-year teaser-rate period. Problems only arose once house prices stopped rising, when refinancing was no longer an option because homeowners would not have the equity they needed to qualify for a new mortgage.

The bubble effectively sustained itself by allowing banks to issue bad mortgages to buy homes that otherwise would not have been affordable at their bubble-inflated prices. Furthermore, as previously noted, inflated house prices led to near-record levels of new home construction. This flood of new homes on the market eventually outstripped demand. The vacancy rate for ownership units began to rise in 2005, matching its prior peak in the third quarter of the year. The rate continued to rise through 2006, and by the first quarter of 2007, the vacancy rate on ownership units was 50 percent above its prior peak.

This excess supply put downward pressure on prices,

sending this self-perpetuating process spiraling in reverse. Lower house prices meant that more people were unable to refinance their mortgages. The drop in house prices also meant that a growing number of homeowners owed more on their mortgages than the value of their home. Such a discrepancy hugely increases the likelihood of default, both because homeowners have no equity cushion to get through tough times and because they have little incentive to struggle to pay off a mortgage that exceeds the value of their homes.

The flood of foreclosures increased the supply of homes coming on the market, putting further downward pressure on prices. Lower house prices also directly affected the demand for houses because most homebuyers are current homeowners who sell their old home to buy a new one. With house prices plummeting, many current homeowners would have little or no equity after selling their home, leaving them unable to afford the down payment on a new home.

Most homeowners work hard to pay their mortgage and will cut back on other expenses, take a second job, or do both rather than lose their homes. If they find that they still can't make ends meet, they will generally sell their homes and pay off the mortgage rather than lose whatever equity they had built up, and risk a serious strike on their credit record from defaulting.

As a result, the loan-loss rate on mortgages is typically very low, a good reason banks felt comfortable holding minimal loss reserves against their own mortgages, and mortgage-backed securities (MBSs) generally were thought to be very

secure assets, even if they were not guaranteed by Freddie Mac and Fannie Mae. And Fannie Mae and Freddie Mac themselves were very heavily leveraged; their ratios of assets to capital were more than 50 to 1. They considered large-scale defaults and losses on their mortgages highly unlikely.

In a bursting housing bubble, however, large-scale losses on mortgage debt are guaranteed. Not only was the likelihood of default and foreclosure far higher than normal, but the loss on each foreclosure was far higher. The loss is the difference between the value of the mortgage and what the lender would recover from reselling the home after deducting realtors' fees, legal expense, and other costs associated with the foreclosure. In normal times, the loss on a foreclosed property would be close to 25 percent of the outstanding mortgage.

However, when house prices plummeted, the loss ratio soared. In some cases, foreclosed properties were selling for less than half the value of the outstanding mortgage. Loss ratios reached the neighborhood of 70 to 80 percent after deducting foreclosure-related expenses. The number of foreclosures vastly exceeded normal levels and the loss on each foreclosure ran two to three times normal levels—banks and holders of MBSs were taking very serious hits.

The Bubble and the Economy

The damage the collapse of the bubble wreaked on the financial sector was serious, but even worse was the damage it inflicted on the real economy. The housing bubble had been driving the

economy ever since the 2001 recession. Although that recession was officially short and mild—ending in November 2001, just seven months after it had begun—its effects actually continued to be felt for the next two years. The economy did not start creating jobs again until the fall of 2003.

The collapse of the stock bubble caused the 2001 recession. Although its collapse did not cause nearly as much damage as the subsequent collapse of the housing bubble, it took the housing bubble itself to eventually lift the economy out of its slump. In effect, the growth of a second bubble helped the economy recover from the collapse of the first.

The housing bubble propelled the economy in two ways. First, growth in the housing sector itself became an important source of demand. Housing construction averaged close to 4 percent of gross domestic product (GDP) throughout the post-war period, expanding to a peak of more than 6 percent in 2005. Since the collapse of the housing bubble, the sector has shrunk to less than 3 percent of GDP. This shrinkage represents a loss in annual demand of more than $450 billion a year and represents the loss of millions of jobs in construction, mortgage banking, and real estate.

The housing bubble also drove the economy by stimulating consumption. A well-documented housing wealth effect is that each additional dollar of housing wealth is associated with an increase in annual consumption of five to seven cents. Some evidence showed that this wealth effect may have been even

stronger during this period, as banks made it extremely easy for homeowners to take money out of their homes through refinancing or home-equity loans.

However, even the modest five-to-seven-cents-on-the-dollar increase in consumption implies that the $8 trillion housing bubble led to additional consumption of $400 billion to $650 billion a year. This increase is consistent with the consumption boom we saw at the peak of the bubble, when the savings rate fell to less than zero. In addition, the growth created by the housing bubble helped to spur a recovery of stock prices, which would not otherwise have occurred. The additional stock wealth was in the range of $6 trillion to $8 trillion. If the stock wealth effect on consumption is in the neighborhood of three to four cents on the dollar, the housing bubble indirectly caused an additional $180 billion to $320 billion in annual consumption.

When the housing bubble burst, the bubble-wealth-induced consumption would also inevitably grind to a halt, which is exactly what we have seen in recent quarters. With the collapse of the housing bubble and the loss of more than $6 trillion in stock wealth, the savings rate is now nearly returning to its post-war average of 8 percent, another entirely predictable result of the collapse of the housing bubble.

In short, policymakers should absolutely have anticipated a collapse in demand as a result of the collapse of the housing bubble, precisely as we have seen in the last year. The decline in housing construction has led to a loss in annual demand of more than $450 billion, and the loss of consumption, directly

or indirectly driven by the bubble, led to a further drop of $580 billion to $980 billion. The total loss in annual demand was between $1,030 billion and $1,430 billion, which does not even count the impact of the collapse of a secondary bubble in nonresidential real estate. All told, output has fallen between 8 and 10 percent of GDP.

Those in policymaking positions, first and foremost Alan Greenspan and the Federal Reserve Board, have no excuse for being caught by surprise either by the collapse of the housing bubble or the impact that its collapse had on the economy. It was a disaster waiting to happen. As difficult as it is to believe they did not see it coming, even more incredible is that they saw it and chose to do nothing to prevent it.

What They Could Have Done

Academics, reporters, and people in policy positions have devoted much effort to obfuscating the issues, yet the Fed could have taken clear and concrete steps to stem the growth of the housing bubble before it reached such dangerous proportions. First and foremost, the Fed could have issued clear warnings about the existence and dangers of the bubble.

Issuing a warning doesn't mean muttering "irrational exuberance," as Greenspan famously did in 1996, at the peak of the stock bubble years.[5] It means explicitly laying out the evidence for the existence of a housing bubble. The Federal Reserve Board employs hundreds of economists. Given the

enormous danger presented by the bubble, the most important thing economists should have been doing during the bubble years was to show the public and the financial sector that a bubble existed and would have disastrous consequences when it burst.

Alan Greenspan should have used every one of his testimonies before Congress and every public-speaking engagement to warn about the bubble. He should have instructed all Fed staffers to do the same, constantly highlighting the evidence for a bubble and vigorously challenging any economists who contested this view.

If the Fed had engaged in such a determined effort, the financial markets and individual homebuyers would not have been able to ignore it. At the very least, banks would have been more cautious in the loans they issued or bought. Also, millions of homebuyers almost certainly would have had second thoughts before paying two or three times what a home would have cost a decade earlier.

In addition to pressing the case everywhere for the existence of a housing bubble, the Fed could also have used its regulatory authority to crack down on the proliferation of bad loans. This course was recommended to Greenspan by fellow Fed governor Edward Gramlich.[6] He was worried about the proliferation of adjustable rate subprime loans as early as 2002. Greenspan did not share his concern and did nothing to rein in the growth of these loans.

At the very least, the Fed could have issued mortgage guidelines—promised since the 1990s—for banks to follow

when issuing loans. Such guidelines—which included, for example, that banks should evaluate the borrower's ability to pay ARMs based on likely reset rates rather than teaser rates—were finally issued in preliminary form in December 2007, but did not become finalized until the summer of 2008.

The Fed could have likely reined in the housing bubble by documenting the evidence and warning loudly of the risks, as well as aggressively using its regulatory authority. If the Fed had done everything it could and the bubble had still continued to expand, it should have raised interest rates as much as necessary to burst the bubble. Such an explicit commitment by the Fed to burst the bubble would likely have amplified the effect of raising interest rates and been extremely effective in reining in house prices.

Raising interest rates has the undesirable consequences of slowing the economy and throwing people out of work. Even so, such consequences would have been preferable to letting the bubble continue to grow and ending up with the severe recession we now face. The economic collapse was the worst possible result of a decade of Fed policy. The Fed simply failed disastrously in its conduct of monetary policy—a reality that should by now be very clear to everyone.

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by Dean Baker

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