Grano Series – The Future of the Global Economy

The 5th[d] annual speakers series, held in Toronto at Grano Restaurant, explores the challenges of the global economy given the world-wide recession and market collapse of late 2008.

September 24, 2008

The role of the housing collapse and dysfunctional markets

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The following is an edited transcript of Professor Feldstein's talk at the Grano Lecture. Professor Feldstein teaches at Harvard University and is one of the world's leading macroeconomists

My recent diagnosis of the medium-term outlook for the U.S. economy has been negative.

But in the long-run I really am a long-term optimist about the U.S. economy. Things such as-- the work ethic, the way our capital markets generate capital for new businesses, the entrepreneurial spirit in the economy -- are things that will keep the U.S. economy expanding in the near and distant future. But right now we really are experiencing what I can only say is the worst economic situation, not only in financial markets, but more generally, that I have experienced both as an observer and as a participant in markets over many decades.

What we're seeing now is a combination of a major economic slowdown, a recession -- even though it hasn't been officially designated as such -- and also a crisis in our financial markets. These two are interacting with each other. The slowdown in the economy is making the financial situation worse, and the dysfunctional financial markets are making the recession worse. I say recession even though for those who look for a couple of quarters of GDP as a measure of recession, we haven't seen two quarters of decline in the GDP. But I think that's for technical reasons.

Look at all of the indicators of economic activity. Look at what's happening to employment, which peaked last December and has been lower month after month since then. Look at industrial production, lower

now than at the start of the year. Personal incomes, it is the same thing, lower now than at the start of the year. Personal consumer spending, it’s the same thing. Housing starts are down 40% from a year ago. So there's no doubt that the economy, even before this financial crisis hit, has been sliding into an economic recession.

The financial markets are suffering in a different way. We're seeing a lack of confidence, a subject I'll come back to, a lack of liquidity, an unwillingness to provide credit, and that's going to further hurt economic activity. This downturn, this recession, is really quite different from the recessions that we've had over the last several decades.

In the last 30 years, the U.S. has experienced four recessions -- four times when the economy peaked, went down, and then eventually came back up again. I think this one is going to last longer. I think it's going to get worse before it gets better.

Why? Even before the recent financial problems developed, this economic downturn was fundamentally different from those that went before. If you look at the last several economic downturns, the last several recessions, they were basically caused by a tightening of monetary policy by the Federal Reserve, as it tried to prevent an increase in inflation. Once the Fed had succeeded in doing that, once the high interest rates had slowed the economy down, they reversed the interest rates and the economy came back up. So the last two recessions lasted only eight months from the peak to the trough, because the Fed could turn it off in the same way it had turned it on.

This recession is fundamentally different. It wasn't caused by a tightening of monetary policy by the Fed. So the Fed has not been able to simply reverse direction and pull the economy back out of recession. Indeed, even after the Fed had finally started cutting interest rates and brought our overnight rate down from over 5% to 2%, the economy didn't respond.

It didn't respond because the primary way in which lower interest rates usually turn around a business cycle is through the housing sector. And with housing in the kind of terrible shape that it's in now, a few extra points down in short-term interest rates weren't going to do anything. Long-term mortgage rates have not come down at all either, even though the short rates have.

On top of that, the fact that the financial markets were so dysfunctional meant that the lowering of the interest rates charged by the Federal Reserve didn't flow through the economy, didn't improve the availability of credit or the cost of credit to operating businesses. So we are looking at a very different economy, a very different downturn, and one which could take a very long time to right itself, even apart from the crisis that began last week.

What drove this economy down? Essentially, the culprit is what happened in the housing market. What we've seen in the U.S. housing markets in this decade is an unprecedented combination of three things: a bubble in house prices that went up dramatically, a jump in loan-to-value ratios, and a securitization of mortgages. Those three things combined to produce the toxic situation that we're looking at now.

Let me give you the details, because I think it's very important as one tries to contemplate how we're going to get out of this mess, to understand the way in which the housing sector is central to it. And I'm sorry to say that the housing sector is not at all central to the proposals being discussed in Washington today. The plan that the Treasury has put forward and that Congress is debating does virtually nothing to deal with this problem.

So what is the problem? What is it that happened to housing over this period? First, house prices jumped. A combination of low interest rates and other things caused house prices to rise in the first part of this decade by some sixty percent, six-oh percent, relative to any measure of what was sustainable. If you look at rents, if you look at people's incomes, house prices have just dramatically increased.

That was a bubble that had to reverse itself. It was only a question of when that would happen and how fast those prices would come down. And they started to come down in the middle of 2006. They have now come down about 20%, and experts say it's going to take another 10 or 15% just to get back to that pre-bubble path of house prices. But there's no reason to think that once they get back down to that pre-bubble path, they'll stop falling. Just as they overshot on the upside by 60%, there's a real worry that it could go well below the 15% in further decline that people say is necessary to bring us back to the pre-bubble path.

That risk is related to what happened to loan-to-value ratios. Historically, American mortgages were 75 or 80% of the purchase price. But as we moved into the middle of this decade, creditors were willing to extend credit at 90%, 95%, in some cases 100% of the purchase value of the property. And it wasn't just new home buyers. There was a great surge in mortgage refinancing, in which individuals refinanced their homes, which had gone up substantially in value, took some of that cash to spend on other things, and were able to lower their interest payments because interest rates had come down. We had a surge in loan-to-value ratios.

You ask why any sensible creditor would be willing to lend 90%, 95, 100% on a home mortgage. That answer is simple. Because prices were rising so fast -- double digit annual increases -- that a hundred percent mortgage today would be an 80% mortgage two years from now. So we had a lot of that kind of lending and lo and behold it worked, for a while. As long as prices were going up, the loan-to-value ratios that were put on

the books at a hundred percent came down to more normal numbers within a year or so.

But when house prices stopped going up, that process went into reverse, and loan-to-value ratios, instead of coming down from their initial level, went up. That is the second factor at work in this crisis. We now have a situation in which two million homes in the United States now have loan-to-value ratios greater than a hundred percent. That means they have negative equity. Two million homes, to put it in perspective, is 20% of all of the homes with mortgages in the United States. The total value of those mortgages is something like two trillion dollars.

What you must understand about the U.S. mortgage market that makes it different from the Canadian market, or from virtually every other market of which I am aware, is that these mortgages are non-recourse loans. This means that if an individual defaults, stops paying the mortgage, the creditor can take the property but that's all. They can't come after other assets. They can't come after the individual's income. So there's a very substantial incentive, once you have a substantial negative equity in your home, to walk away knowing that the creditors can't come after you for anything else. And that has been happening.

We've seen a tripling in the rate of default and foreclosure in the last 18 months, still relatively low given the number of homes with negative equity. But the extent of negative equity is growing, and that is driving the fear that there will be more defaults and more foreclosures. The process is dangerous because as individuals default and their property is foreclosed, that puts more housing stock on the market. That drives down the price of houses. A fall in the value of homes increases the number of homes with negative equity and increases the magnitude of the negative equity in those homes, providing an increased incentive for people to default.

That leads to defaults, foreclosures and declining prices. That is the greatest worry hanging over the financial markets now -- the prospect of a downward spiral in house prices. It is those house prices that underlie the mortgage-backed securities.

That is the third piece of what I said was this unique combination of a bubble in house prices, high loan-to-value ratios, and securitizations. It wasn't that many years ago that the typical mortgage was initiated by a local bank or a savings and loan association and kept in portfolio by that institution. Or it was sold to Fannie and Freddie.

But now we've moved into a completely new world in which virtually all of these mortgages are securitized -- and not just securitized into plain vanilla pools of mortgages -- but rather into exotic CDOs, credit default swaps and collateralized debt obligation. Those in turn have been put into different risk classes, different tranches, so that the investors holding these are not holding mortgages but rather a potential interest in a payment stream conditional on how others get paid.

It also means that individuals don't have anybody to negotiate with if they want to go to their neighbourhood bank and say that their mortgage is now very big relative to the value of their house; that they do or don’t wish to default; that they want to work out a deal. There's nobody to work out a deal with, because that mortgage has disappeared from the local market and been securitized into these new and rather exotic securities.

That's what we're seeing. We're seeing that commercial banks, insurance companies and investment banks have portfolios of these mortgage-backed securities. And nobody knows quite how to value them, because we don't know what's going to happen to house prices. Therefore, we don't know what's going to happen to defaults and foreclosures and this whole downward spiral.

There's a lack of confidence on the part of portfolio holders in the value of their own securities. So the financial institutions themselves, the investment banks, are not sure what assets they’re holding or what they're worth. So they're very nervous about how much capital they have and therefore how much lending they're willing to do.

They also don't have confidence in counterparties. If you don't know what the other fellow's balance sheet is worth and you don't know how much liquidity he has, you don't want to lend to him. As a result, we're seeing this seizing up of the financial markets because of a lack of confidence on the part of the participants in counterparties and in their own situation.

That's the problem the administration is trying to solve, and in its proposal to do so the Treasury has asked Congress for a 700 billion dollar blank cheque. They have asked for 700 billion dollars which, even considering the size of the American economy, is a big number. They have asked for 700 billion dollars to buy back some of these underwater mortgage-backed securities. This is in order to provide liquidity for the institutions, to start lending money again and to improve balance sheets so that these institutions feel better about lending.

Those are certainly three good things to want to do but I think that the Treasury's proposal as originally put forward couldn't really do that. It could not create that kind of liquidity or confidence. As long as an institution still holds significant numbers of mortgage-backed securities, as long as the government hasn't taken them all away and as long as there isn't a potential further flow of new problems as house prices come down, you're not going to have confidence in the credit-worthiness or the liquidity of that institution.

While 700 billion dollars sounds like a lot of money, it wouldn't begin to buy out all of what people call the “toxic paper” in financial institutions. So I don't think they can produce confidence in this way. Can they produce liquidity? Yes, they can exchange government securities, liquid securities,

for mortgage-backed securities. But it's not at all clear that the institutions are going to take that as an occasion to do new lending.

There's such a desire to build up liquidity that it may simply, with the amounts involved, have the effect of causing these funds to be held in portfolio. So I think we're not going to see the improvements in confidence or the improvements in liquidity that we might like. We're not going to put that to a test, though, because I think Congress is not going to go along with this plan.

Congress is already very unhappy with this proposal, and that seems to be true on both the left and the right. People I've talked to in Washington have confirmed that. So at this point the Treasury keeps modifying what it's trying to do and the technical ways in which it would do it, but we don't know what the Treasury really wants to do with 700 billion dollars. I think that's because the Treasury doesn't know what it wants to do with 700 billion dollars. And Congress is not going to authorize them to work it out after they get the money.

What can be done about all of this? I think there is a solution. I think that if you want to stabilize this market -- and this is what I want to conclude with and then I'm really looking forward to your questions – and you want to give people confidence in the value of mortgage-backed securities, then you have to stabilize house prices. You have to stop this risk of a downward spiral in house prices being fed by foreclosures.

How could you do that? I don't think it's an easy problem, but I think there is one way the government could solve it. That is to offer to current individuals with mortgages -- not the ones that are under water, not the ones with negative equity, but the 80% of people with positive equity in their mortgages -- a chance to substitute a lower interest government loan for a part of that mortgage.

Let me explain the logic of this. The danger is that if I have a mortgage now with a loan-to-value ratio of 90% and house prices fall another 15 or 20%, then I'm going to be one of those people with negative equity thinking about turning in the keys, adding to the volume of houses on the market and pushing prices down. So I imagine the government coming to me and saying, "Well Marty, you have a 90% loan-to-value ratio and we will buy out one-fifth of that. We will replace one-fifth of your mortgage, if you want, with a low interest loan reflecting the government's cost of funds." If I'm a typical homeowner, that doesn't sound like a bad deal. I'm going to get a low interest loan.

What's the catch? The loan from the government would not be associated with the house and it would be a loan that you had to pay back. It would be a loan with full recourse. The government would have a claim on your assets or your income if you didn't make your payments on this, say, 20 or 30 year loan. The government, remember, is in a position to

know a lot about your income and your assets, so people are going to want to pay back these loans.

That's the basic idea. If I start with a 90% loan-to-value ratio and I accept the government's 20%, then my 90% loan-to-value ratio will go down to 72%. And then it would take an enormous fall in house prices for me to be facing a negative equity situation. So I think that would stabilize the situation.

A lot of people who aren't anywhere close to a hundred percent would benefit from this. Maybe you could find ways of reducing the total cost to the government of this program. But it would certainly be a way of stabilizing the situation and putting up a barrier against further falls in these prices. It would also liquefy the institutions, because a fifth of their mortgages would be converted into government bonds. I'd put a dollar limit on this so it wouldn't be for very high income earners, or very high value homes. But it would put a substantial amount of liquidity into the system, which would stop the downward spiral of house prices.

I don't expect the Congress to come rushing to legislate this in the next few weeks. It's a pity. It would have been even better if they would have done it six months ago, but after the election, when people can think more calmly about these issues, I think something like this may be necessary. So let me stop there and see what questions you have about anything that I've said, or about anything else you want to ask about.