
Special Topic: Crash of 2008

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Introduction

Special Topic: The Crash of 2008: Cause and Aftermath

By James Gwartney, David Macpherson, Russell Sobel, and Richard Stroup*

U.S. housing policies are the root cause of the current financial crisis. Other players--"greedy" investment bankers; foolish investors; imprudent bankers; incompetent rating agencies; irresponsible housing speculators; shortsighted homeowners; and predatory mortgage brokers, lenders, and borrowers--all played a part, but they were only following the economic incentives that government policy laid out for them.

Peter J. Wallison¹

Focus Questions

- What caused the Crisis of 2008?
- Why did housing prices rise rapidly during 2001-2005 and then fall in the years immediately following?
- Did the housing crisis arise because the regulators were asleep on the job?
- Is the U.S. economy headed toward another Great Depression?
- Is there a Crisis of Capitalism? Is there a Crisis of Political Decision-making?

* Endnotes

James Gwartney, David Macpherson, Russell Sobel, and Richard Stroup are co-authors of *Economics Private and Public Choice* (South-Western/Cengage Learning, 2009), a widely used principles of economics text now in its 12th edition.

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Wallison, Peter J., "Cause and Effect: Government Policies and the Financial Crisis," AEI Financial Services Outlook: www.aei.org/publication29015

The Crisis of 2008 will probably be the most important macroeconomic event of our lives. Thus, it is vitally important for each of us to understand what happened, why things went wrong, and the lessons that need to be learned from the experience. This crisis is a story about lower mortgage credit standards, loans extended with little or no down payment, manipulation of short-term interest rates by the Fed, and imprudent leveraging of mortgage-backed securities by Wall Street investment geniuses.

Initially, these actions increased the demand for housing and drove housing prices upward. But, it was only a matter of time until these conditions reversed. High risk loans led to an increase in the default rate. The Fed's low interest rate policy of 2002-2004 pushed prices upward in 2005. As the Fed responded with higher short-term interest rates, the monthly payments for borrowers with variable rate mortgages increased. By 2006 housing prices had leveled off and they soon began to fall. Those who purchased housing with little or no down payment were soon upside down – their mortgages were greater than the value of their houses. As the percentage of persons running behind on their mortgage payments increased, highly leverage mortgage-backed securities collapsed along with the investment banks that provided them. All of these forces culminated in the Crisis of 2008. The stock market plunged, causing trillions of dollars of wealth and retirement savings to vanish. Confidence evaporated, real output fell, and the rate of unemployment rose sharply.

Let's take a closer look at these events and the economic forces that underlie them.

Key Events Leading up to the Crisis

The housing boom and bust during the first seven years of this century is central to understanding the economic events of 2008. As Exhibit 1 shows, housing prices were relatively stable during the 1990s, but they began to rise toward the end of the decade. By 2002, housing prices were booming. Between January 2002 and mid-year 2006, housing prices increased by a whopping 87 percent. This translates to nearly 15 percent annually. But the housing boom began to wane in 2006. Housing prices leveled off and by the end of 2006, they were falling. The boom had turned to a bust, and the housing price declines continued throughout 2007 and 2008. By the third quarter of 2008, housing prices were approximately 25 percent below their 2006 peak.

Exhibit 2a presents data on the mortgage default rate from 1979 through 2008 (note: the default rate is also known as the serious delinquency rate). As these figures illustrate, the default rate fluctuated, within a narrow range, around 2 percent prior to 2006. It increased only slightly during the recessions of 1982, 1990, and 2001. However, even though the economy was relatively strong and unemployment low, the default rate began increasing sharply during the second half of 2006. By the fourth quarter of 2007, it had already risen to 3.6 percent, up

from 2.0 percent in the second quarter of 2006. The rate continued to rise, reaching 5.2 percent during the third quarter of 2008.

As Exhibit 2b illustrates, the mortgage foreclosure rate followed a path similar to the default rate. The foreclosure rate was low and relatively steady prior to mid-year 2006, at which time it increased sharply and moved to the highest level in decades.

During 2008, housing prices were falling, default rates increasing, and the confidence of both consumers and investors deteriorating. These conditions were re-enforced by sharply rising prices of crude oil, which pushed gasoline prices to more than \$4 per gallon during the first half of the year. Against this background, the stock market took a huge tumble. Exhibit 3 presents data on the changes in the S & P 500 index of stock prices each year since 1950. During 2008, stock returns fell by 37 percent. This is nearly twice the magnitude of any year during this era. This collapse eroded the wealth and endangered the retirement savings of many Americans.

What Caused the Crisis of 2008?

Why did housing prices rise rapidly, then level off and eventually collapse? Why did the mortgage default and housing foreclosure rates increase so rapidly even before the beginning of the current recession, which did not start until December of 2007. Why are the recent default and foreclosure rates so much higher than the rates of earlier years, including those present during recessions? Why did large, and seemingly strong, investment banks like Bear Stearns and Lehman Brothers run into financial troubles so quickly? Four factors combine to provide the answers to all of these questions.

Factor 1: Change in Mortgage Lending Standards

The lending standards for home mortgage loans changed substantially beginning in the mid-1990s. The looser lending standards did not just happen. They were the result of federal policy designed to promote more home ownership among households with incomes below the median. While home ownership is a worthy goal, it was not pursued directly through transparent budget allocations and subsidies to homebuyers. Instead, the federal government imposed a complex set of regulations and mandates that forced various lending institutions to extend more loans to low- and moderate-income households. In order to meet these mandates, lending standards had to be reduced. By the early years of the 21st century, it was possible to borrow more (relative to your income) and purchase a house or condo with a lower down payment than was the case a decade earlier.

The Federal National Mortgage Association and Federal Home Loan Mortgage Corporation, commonly known as Fannie Mae and Freddie Mac, played a central

role in this relaxation of mortgage lending standards. These two entities were created by Congress to help provide liquidity in secondary mortgage markets. Fannie Mae, established by the federal government in 1938, was spun off as a "government sponsored enterprise" (GSE) in 1968. Freddie Mac was created in 1970 as another GSE to provide competition for Fannie Mae.

Fannie Mae and Freddie Mac were privately owned (for profit) businesses but, because their bonds were backed by the federal government, they were able to borrow funds at 50 to 75 basis points cheaper than private lenders. This gave them a competitive advantage and they were highly profitable for many years. However, the GSE structure also meant they were asked to serve two masters: their stockholders, who were interested in profitability, and Congress and federal regulators, who predictably would be more interested in political objectives.

As the result of their GSE structure, Fannie Mae and Freddie Mac were highly political. The top management of Fannie and Freddie provided key congressional leaders with large political contributions and often hired away congressional staffers into high paying jobs lobbying their former bosses. Between the 2000 and 2008 election cycles, high-level managers and other employees of Fannie Mae and Freddie Mac contributed more than \$14.6 million to the campaign funds of dozens of senators and representatives, most of who were on congressional committees important for the protection of their privileged status. The lobbying activities of Fannie Mae and Freddie Mac were legendary. Between 1998 and 2008, Fannie spent \$79.5 million and Freddie spent \$94.9 million on congressional lobbying, placing them among the biggest spenders on these activities. They also set up "partnership offices" in the districts and states of important legislators, often hiring the relatives of these lawmakers to staff these local offices.² While it was a relationship that, at the very least, bordered on corruption, members of Congress, particularly those involved in banking regulation, were highly supportive because Fannie Mae and Freddie Mac were reliable sources of campaign contributions and other valuable political resources. (Note: The relationship between the GSEs and Congress provides a vivid illustration of the special interest effect discussed in *Common Sense Economics*, part 3, element 4.)

Fannie Mae and Freddie Mac did not originate mortgages. Instead they purchased the mortgages originated by banks and other mortgage brokers. Propelled by their cheaper access to funds, Fannie Mae and Freddie Mac dominated the home mortgage market. As Exhibit 4 shows, the share of all mortgages held by Fannie Mae and Freddie Mac rose from 25 percent in 1990 to 45 percent in 2001. Their share has fluctuated modestly around 45 percent since 2001. During recent years, Fannie Mae and Freddie Mac have purchased about 90 percent of the mortgages sold in the secondary market. Because of their dominance of the secondary mortgage market, their credit standards exerted a huge impact on the standards accepted by mortgage originators.

In the mid-1990s, when the Department of Housing and Urban Development (HUD) imposed regulations designed to make housing more affordable, Fannie Mae and Freddie Mac were required to increase the share of loans they extended to low and moderate-income households. For example, HUD mandated in 1996 that 40 percent of new loans financed by Fannie Mae and Freddie Mac had to go to borrowers with incomes below the median. This mandated share was steadily increased to 50 percent in 2000 and 56 percent in 2008. Similar increases were mandated for borrowers with incomes of less than 60 percent of the median. In 1999, HUD guidelines required Fannie Mae and Freddie Mac to accept smaller down payments and extend larger loans relative to income. This expansion in mortgage financing increased the demand for housing and placed upward pressure on housing prices during 2000-2005.

Because Fannie Mae and Freddie operate in the secondary market, their policies affected the actions of banks and other mortgage lenders. Recognizing that the riskier loans could be passed on to Fannie and Freddie, mortgage originators had less incentive to scrutinize the credit worthiness of borrowers. The bottom line: required down payments were reduced and the accepted credit standards lowered.

In 2003 and 2004, both Fannie Mae and Freddie Mac were involved in major accounting scandals. They had manipulated their accounting figures in order to exaggerate their net income. As the result of this misrepresentation the CEOs and other high-level executives of both were either dismissed or forced to resign. In the aftermath of these scandals, Congress considered legislation in 2005 that would have provided more careful oversight of the GSEs and prohibited them from holding portfolios of mortgage-backed securities. But the legislation was blocked by key congressional supporters of Fannie and Freddie. Interestingly, had the legislation passed, the prohibition on the holding of portfolios of mortgage-backed securities would have saved taxpayers tens of billions of dollars in the years immediately ahead.

Following the accounting scandals, Fannie Mae and Freddie Mac moved even more aggressively to extend more loans with little or no down payments and to borrowers with lower incomes and credit ratings. Presumably, this shift was an effort to shore up their congressional support, which had been damaged by the accounting scandals. During 2005-2007, Fannie and Freddie increased their holdings of sub-prime and other questionable loans. Their increased holdings of sub-prime loans is particularly important because the default rate on sub-prime loans is nearly ten times the rate for loans in the prime category. In his September 23, 2008 testimony before Congress, James Lockhart, the director of the Federal Housing Finance Agency, cited the increase in sub-prime and poorly documented loans as the reason for the 2008 collapse of the GSEs.

How lax were the credit standards of the GSEs? The data provided to the public makes it difficult to answer this question with precision. However, disclosures

from Freddie Mac provide some insight. These disclosures indicate that, for the single-family loans added to its portfolio during 2005 -2007, 97 percent were interest-only mortgages, 68 percent had original loan-to-value ratios greater than 90 percent, and 67 percent were extended to borrowers with FICO scores lower than 620. Note: federal bank regulators define a loan as sub-prime if the borrower's FICO score is less than 660.

The mortgage credit standards were also altered by the 1995 modifications of the Community Reinvestment Act (CRA). The original act, passed in 1977, prohibited discriminatory lending practices by banks and other lenders. It specifically prohibited red-lining, a technique whereby lenders would refuse to extend loans for housing in certain areas, particularly those with high minority population. The act stated that loans should be made equally available to all qualified borrowers within the context of safe and sound lending practices.

The CRA exerted little impact on either credit standards or the operation of the mortgage lending market prior to the mid-1990s. However, in 1995, the Clinton Administration issued new regulations requiring lenders to meet numeric goals based on the minority population in the area served by the lender. Essentially, the regulations imposed a quota system on the mortgage loans of banks. Because of differences in the income and credit records of whites and minorities, it was particularly difficult for banks operating in areas with sizeable minority populations to meet these quotas. In order to do so, many banks lowered their lending standards for loans extended to minorities. Thus, like the regulations applied to the GSEs, the 1995 modifications to the Community Reinvestment Act increased the volume of loans to borrowers who did not meet the conventional criteria to qualify for a mortgage.

It is interesting to reflect on the issue of whether the relaxation of credit standards helped low and moderate income households who were enabled to purchase housing with little or no down payment or more expensive housing relative to their income. In many cases, the answer is clearly, "No." In essence, Congress acting through the GSEs and the Community Reinvestment Act provided households with the means to take on excessive debt, which led to financial troubles and emotional anxieties. (Note: See part 4, particularly element 3 of *Common Sense Economics* about the dangers of excessive debt) The effects of policies are often quite different than the intent of the proponents.

The lower lending standards resulting from the GSE and CRA regulations reduced lending standards across the board. Lenders could hardly offer low-down payment loans and larger mortgages relative to housing value to sub-prime borrowers, without offering similar terms to prime borrowers. Historically, conventional loans, 30-year fixed interest rate mortgages with a 20 percent down payment dominated the home mortgage market. But this changed dramatically during the early years of this century. According to data published by the Joint Center for Housing Studies of Harvard University, conventional loans as a share

of all mortgages originated fell from 57.1 percent in 2001 to 33.1 percent in the fourth quarter of 2006.³

Factor 2: Prolonged Low-Interest Rate Policy of the Fed during 2002-2004

Following the high and variable inflation rates of the 1970s, Federal Reserve policy-makers focused on keeping the inflation rate low and stable. By the mid-1980s, the inflation rate had been reduced to 3 percent, and monetary policy-makers avoided abrupt year-to-year changes in the general level of prices over the next two decades. In turn, the relative price stability reduced uncertainty and created an environment for the smooth operation of markets. During this era, it was widely believed that price stability was the only objective that could be achieved with monetary policy, and if this objective was achieved, the monetary policy-makers would have done all they could do to establish conditions consistent with strong growth and high levels of employment.

However, as the lessons of this period began to dissipate, Fed policy-makers including Chairman Alan Greenspan began to focus more on control of real variables such as employment and real GDP. As Exhibit 5 shows, the Fed injected additional reserves into the banking system and kept short-term interest rates at historic lows throughout 2002-2004. The federal funds interest rate was maintained at 2 percent or less for more than three years. The Fed's stated objective was to stimulate real output and employment as the economy was recovering from the 2001 recession.

The extremely low short-term interest rates increased the demand for interest sensitive goods like housing and automobiles. But the artificially low rates also made adjustable rate mortgages more attractive and created an incentive for lenders to finance mortgages with short-term assets. Adjustable rate mortgages jumped from 17 percent of the total during 1998-2001 to 33 percent during 2004-2005. The low initial interest rates on adjustable rate mortgages made it possible for home buyers to afford the monthly payments for larger, more expensive homes. But they also meant that as short-term interest rates increased from the historic low levels, home buyers would face a higher monthly payment two or three years in the future. Unsurprisingly, this is precisely what happened.

By 2005, the expansionary monetary policy of 2002-2004 was clearly placing upward pressure on the general level of prices. The Fed responded with a shift to a more restrictive monetary policy, which pushed interest rates upward. This soon increased the interest rates on adjustable rate mortgages and confronted those borrowers with higher monthly payments for their housing. Many of the borrowers were ill prepared to deal with this situation and therefore the default rate soon began to rise more rapidly.

By now the numbers should begin to make some sense. Federal regulations loosened lending standards and mandated that banks extend higher-risk loans to persons less able to handle the debt. This, along with the Fed's low-interest rate policy, expanded credit and increased the demand for housing. As Exhibit 1 shows, housing prices rose rapidly during the first few years of this century. But the housing price increases were the result of policies that were sure to have secondary effects. The increase in the share of loans extended to high risk borrowers who had little or no down payment would soon lead to a higher default rate. Similarly, the low interest rates that made adjustable rate mortgages attractive during 2004 would become highly unattractive as the Fed pushed short-term interest rates up in 2005 and 2006. These two factors would converge and lead to falling housing prices and rising mortgage default rates beginning in the second half of 2006. These patterns can clearly be seen in the data of Exhibits 1 and 2.

Regulatory and monetary policies, particularly the low-interest rate policy of the Fed, encouraged decision makers to borrow more money, and make additional investments in everything from housing to factories. Unfortunately, from an economic standpoint, these are investments that should have never been undertaken, something economists call **mal-investment**. To get the U.S. economy back on track, these mal-investments must be cleansed from the system. This will be a painful and costly process, but it is a necessary part of the recovery.

Factor 3: The Increased Debt/Capital Ratio of Investment Banks

Why did the major investment banks collapse in 2008? A rule change adopted by the Securities and Exchange Commission (SEC) in April of 2004 made it possible for investment banks to increase the leverage of their investment capital. A leverage ratio is simply the ratio of a firm's debt to its assets. For example, if a business had \$3,000 in debt and \$1,000 in equity capital, it would be leveraged at a ratio of 3 to 1. At the urging of leaders of the investment community, including Henry Paulson who was CEO of Goldman Sachs at the time, the SEC allowed the maximum leverage ratio for these banks to be increased to as high as 40 to 1.

Essentially, the SEC applied regulations known as Basel I, to investment banking. These regulations, which have been adopted by most of the industrial countries, require banks to maintain at least 8 percent capital against assets like loans to commercial businesses. This implies a leverage ratio of approximately 12 to 1. However, The Basil regulations provide more favorable treatment of residential loans. The capital requirement for residential mortgage loans is only 4 percent, which implies a 25 to 1 leverage ratio. Even more important, the capital requirement for low-risk securities is still lower at 1.6 percent. This means that if low-risk mortgages could be bundled together and financed with securities, the

capital requirement for these assets would be only 1.6 percent, implying a leverage ratio of more than 60 to 1.

Based on the low default rates prior to 2005 (see Exhibit 2a), both the major investment banks and the security rating firms thought these securitized mortgages were low risk. Thus, they were given AAA ratings. Large investment banks, like Lehman Brothers, Goldman Sachs and Bear Stearns, bundled mortgages together and borrowed funds for their finance from lenders seeking higher returns than were available from money market mutual funds and other short-term financial instruments. The mortgage-backed securities were thought to involve minimal risk because of the diversity of the mortgages in the underlying portfolio. This diversity did provide lenders with protection against abnormally high default rates by borrowers in a specific category or region. But it did not shield investors and the financial markets from the risk of a substantial increase in the overall default rate.

While the lower capital requirements for these mortgages encouraged investment banks to move in this direction, no one forced them to do so. Moreover, the banks failed to recognize that the housing regulations had increased the risk accompanying mortgage loans. The low default rates used to calculate the returns on the securitized mortgages were for periods of either rising housing prices (2000-2005) or when borrowers were required to make sizeable (e. g., 20 percent) down payments against the purchase price of their house. But these lending standards had been eroded by the housing regulations. Borrowers were now able to obtain larger loans with lower down payments than had previously been the case.

By 2006 the combination of a leveling off of housing prices and rising short-term interest rates was pushing up monthly payments and putting the squeeze on households, particularly those who purchased their housing with little or no down payment and an adjustable rate mortgage. The default rate soon began to rise and it soared as housing prices fell throughout 2007 (see Exhibit 2a). As the default rates rose and the riskiness of these mortgages became apparent the value of the mortgage-backed securities plummeted. The money borrowed to purchase these securities was short-term debt, which meant that it had to be paid back very quickly. When the value of the mortgage-backed securities collapsed, the highly leveraged investment banks faced massive short-term debt obligations with few reserves on which to draw. This is why the investment banks collapsed so quickly. In fact, when the Fed financed the acquisition of Bear Stearns by JP Morgan Chase, the leverage ratio of Bear Stearns was an astounding 33 to 1.

High-level decision-makers at the major investment banks apparently failed to recognize that loans extended with little or no down payment to borrowers with lower incomes would have a higher default rate. Moreover, it would be extremely dangerous to finance these loans with highly leverage capital. This failure is a

sorry reflection on both the economic reasoning and judgment of these executives.

Factor 4: High Debt/Income Ratio of Households

High household debt also contributed to the collapse of 2008. As Exhibit 6a illustrates, household debt has grown to unprecedented levels during the past two decades. Between 1950-1980, household debt as a share of disposable (after-tax) income ranged from 40 percent to 60 percent. However, since the early 1980s, the debt to income ratio of households has been climbing at an alarming rate. It reached 135 percent in 2007, more than twice the level of the mid-1980s. Unsurprisingly, more debt means that a larger share of household income is required just to meet the interest payments. As Exhibit 6b illustrates, today, interest payments consume nearly 15 percent of the after-tax income of American households, up from about 10 percent in the early 1980s. (Note: As the introduction to part 4 of *Common Sense Economics* indicates, even though the incomes of Americans are exceedingly high, many live with financial stress. The high debt to income ratio shown here underlies this apparent paradox. The principles outlined in part 4 of CSE explain how this pitfall can be avoided.)

Interest payments on home mortgages and home equity loans are tax deductible, but household interest on other forms of debt is not. This incentive structure encourages households to hold most of their outstanding debt against their house so it will be tax deductible. It also reduces the incentive of homeowners to build equity in their house and results in high mortgage-to-house value ratios. But these conditions mean that housing will be hardest hit by any unexpected events that force heavily indebted households to make adjustments.

This is precisely what happened when rising short-term interest rates began pushing up the monthly interest payments on adjustable rate mortgages in 2005 and 2006. Because they were so heavily indebted, households had neither savings nor much in the way of housing equity to deal with the situation. Thus, as housing prices leveled off and then began to decline during the latter half of 2006, as Exhibit 2 shows, this quickly led to a sharp increase in the mortgage default rate. It also quickly resulted in a sky rocketing foreclosure rate, because owners with little or no initial equity, simply walked away when their loans exceeded the value of their house.

The rapid rise in the foreclosure rate was concentrated among adjustable rate mortgages. Exhibits 7a and 7b presents, for subprime and prime mortgages, the foreclosure rate for fixed and adjustable rate mortgages. Three important points are worth noting about these figures. First, compared to their prime borrower counterparts, the foreclosure rate for subprime borrowers is approximately 10 times higher for fixed rate mortgages and 7 times higher for adjustable rate mortgages. Second, there was no trend in the foreclosure rate prior to 2006 for

adjustable rate or fixed rate mortgages. Third, starting in 2006 there was a sharp increase in the foreclosures on adjustable rate mortgages and this was true for both prime and subprime borrowers. In fact, the increase in the foreclosures on adjustable rate mortgages was greater for prime than for sub-prime loans. In contrast, there was only a modest increase in the foreclosure rate of borrowers with fixed interest rate loans. And this was the case for both the prime and sub-prime borrowers.

The huge increase in the foreclosure rate for adjustable rate mortgages indicates that the abolition of the significant down payment standard and the Fed's low interest rate policy was a lethal combination. It made it possible for buyers to purchase more housing than they could afford with a small investment and modest monthly payment for two or three years until the variable interest rate was reset. Based on the rising housing prices of 2000-2005, many of these investors expected to sell the house for a profit and move on in a couple of years. Thus, the variable rate mortgages were highly attractive to these buyers. There were even television programs and investor seminars pushing this strategy as the route to riches. In essence, once the housing regulations virtually eliminated the down payment requirement, housing buyers could gamble with someone else's money. This is what many did, and when the gamble on higher housing prices failed to materialize, they simply walked away. As the data of Exhibits 7a and 7b show, prime borrowers played this game every bit as much as those with sub-prime credit.

It is important to note that both the mortgage default and foreclosure rates soared well before the recession began in December 2007. This illustrates that the housing crisis was not caused by the recession. Instead, it was caused by perverse housing regulations, the Fed's improper manipulation of interest rates, imprudent leveraging by investment banks, and the large loans and small equity of housing purchasers. With time, of course, the housing collapse spread to the rest of the economy, leading to rising unemployment, plummeting auto sales, sharply lower stock prices, and other indicators of recession. But these affects occurred well after the housing industry was already in dire straits.

Did the Housing Crisis Arise Because the Regulators were Asleep?

Some argue that the current crisis resulted because the regulators were asleep on the job. The opposite is more nearly the truth. The regulators, with the backing of Congress and two presidents, were busy imposing regulations and mandates designed to increase home ownership. They have had a degree of success: home ownership has increased by approximately 5 percentage points during the past 15 years.

But the actions of the regulators deliberately weakened lending standards and thereby encouraged imprudent choices by both lenders and borrowers. Using HUD and the Community Reinvestment Act, the regulators mandated and pressured Fannie Mae, Freddie Mac, and commercial banks to extend loans with little or no down payment, make large loans relative to income, extend loans to households who could not afford the monthly payments, accept poorly documented loan applications, and make more “interest only” and variable rate mortgages. Essentially, the regulators undermined the traditional practices of the mortgage lending industry and replaced it with a system that encouraged lenders to make imprudent loans and borrowers to make only small down payments and borrow more funds than they could afford. Coupled with the Fed’s interest rate manipulation, the change in lending standards engineered the run up in housing prices, its reversal, the rapid increase in mortgage defaults and foreclosures, the troubles of lending institutions, and the culmination of all of these factors with the Crisis of 2008.

Greedy lenders and real estate agents, incompetent rating agencies and imprudent borrowers are sometimes blamed for the current crisis. These players did play a role, but it hardly seems fair to blame them for responding to incentives and doing exactly what the government policies encouraged them to do. The housing crisis would not have occurred if government policy had not encouraged buyers to purchase housing with little or no down payment, forced banks to make mortgage loans they otherwise would never have made, adopted lower capital requirements for housing loans than for other types of loans, and followed a tax policy that encouraged borrowing against housing equity. (Note: As part 1, key element 1 of *Common Sense Economics* indicates incentives matter.)

Are We Headed Toward Another Great Depression?

Many are currently asking this question. As we think about it, we need to recognize where we are. The U.S. economy was very stable during the 25 years prior to the current recession. During 1983-2007, the United States experienced only two short downturns and a total of 17 months of recession. As the result of this era of stability, there is a tendency to exaggerate the severity of the current recession.

Exhibit 8a presents the peak monthly unemployment rate for the most severe recessions since 1970. At year-end 2008, the unemployment rate was 7.2 percent and it will surely go higher. But this is not unprecedented in the post World War II era. The unemployment rate rose to 9.6 percent during the 1974-75 recession, and to 10.8 percent during the 1980-1982 recession. Even during the relatively short recession of 1990-1991, the unemployment rate rose to nearly 8 percent and it remained at or near 7 percent for almost two years.

How do the current unemployment figures compare with the Great Depression? Exhibit 8b shows the unemployment rates during the Great Depression. The

unemployment rate soared to nearly 25 percent of the labor force during the Great Depression and it was 14 percent or more every year throughout 1931-1939. The unemployment rate stood at 17 percent in 1939; a full decade after the catastrophic downturn started. Clearly, the current situation does not approach these conditions.

Why did the Great Depression last so long and why was it so severe? There were four major reasons for the length and severity of the Great Depression. First, monetary policy was perverse. Policymakers allowed the money supply to decline by approximately 30 percent between 1929 and 1933, and it took another tumble during 1937-1938. This reduced aggregate demand and sent the economy into a downward spiral. Second, the infamous Smoot-Hawley trade bill passed in 1930 increased tariffs by approximately 50 percent, causing the volume of international trade and the gains from that trade to shrink by a similar amount. Third, a huge tax increase in 1932 reduced demand and undermined the incentive to invest and produce. Fourth, the numerous policy changes instituted by the Roosevelt Administration created uncertainty and undermined private sector recovery.

Many readers may have been taught that the New Deal policies led to the recovery from the Great Depression. Even a casual inspection of the data indicates this is a myth. As we noted, the unemployment rate was 17 percent in 1939, seven years after the beginning of the Roosevelt presidency. Some of the New Deal policies were helpful (e. g. Federal Deposit Insurance) but others were clearly counterproductive (e. g. the National Recovery Act and the Agriculture Adjustment Act). Further, the numerous policy changes of the New Deal era created uncertainty and undermined the long-term planning of both businesses and potential investors. Roosevelt's Treasury Secretary Henry Morgenthau tried without success to get the president to make a public statement to reassure investors and the business community.⁴ Lammont du Pont highlighted the uncertainty generated by the constant whirlwind of New Deal policy changes when he stated:

Uncertainty rules the tax situation, the labor situation, the monetary situation, and practically every legal condition under which industry must operate. Are taxes to go higher, lower or stay where they are? We don't know. Is labor to be union or non-union? Are we to have inflation or deflation, more government spending or less?. Are new restrictions to be placed on capital, new limits on profits? It is impossible to even guess at the answers.⁵

The Great Depression provides policymakers with considerable direction regarding what not to do. Clearly, monetary contraction, trade restrictions, tax increases, and a multitude of policy changes will be counterproductive. There are signs that some of these lessons have been learned. The Fed has injected a huge quantity of reserves into the banking system and the money supply is

now growing rapidly. Thus, it is a virtual certainty that there will not be a contraction in the money supply. While there has been some talk of various types of trade restrictions and tax increases, major actions in these areas also seem unlikely.

Though these factors provide reasons for optimism, there are also some troublesome signs. As we have discussed, the indebtedness of American households is at an all-time high. Americans are now in the process of trying to reduce their outstanding debt. In some cases, higher credit standards will force them to do so. In other instances, housing foreclosures and other experiences with excessive debt will alter spending behavior. Thus, spending on big-ticket items like autos and houses is almost sure to be weak during the next couple of years.

The heavy indebtedness of American households will also tend to undermine the effectiveness of government efforts to stimulate the economy. Tax cuts and sending out so-called “stimulus checks” (as was done during the second quarter of 2008) will do little to increase aggregate demand because a substantial share of these windfalls will be saved or used to pay down debt. Even increases in government spending on infrastructure will exert only a limited impact as substantial portions of any increase in income will be used to pay down outstanding debt. All of this suggests that the current recession will be lengthy.

There is also a troublesome parallel between recent policy responses and those during the Great Depression. During 2008, the policies were changing weekly, if not daily. Further, they were unpredictable. Americans were told that financial doomsday would occur unless the Treasury was provided with \$700 billion to purchase the bad loans of financial institutions that were clogging up credit markets. However, after the funds were allocated, the Treasury couldn’t figure out how to buy the “toxic assets”, so they used the funds to bail out troubled firms, including \$10 billion for Goldman Sachs, the investment bank previously headed by Treasury Secretary Henry Paulsen. The Fed provided financing for the rescue of some institutions (e.g. Bear Stearns, AIG and Citigroup), but not others (Lehman Brothers). The Big 3 American automakers were not going to be bailed out, then they were.

As some firms and industries are bailed out, others get in line. All of this creates uncertainty and at this point, there is no end in sight. Which firms or industries will be bailed out next? Will subsidies be provided to those behind on their mortgage payments? If federal assistance is provided to homebuyers, who will qualify and how much aid will be provided? Uncertainty about what policymakers will do causes private decision-makers to delay actions as they wait to see what happens. Moreover, the constant policy changes encourage businesses to spend more time seeking “profits” in Washington and less time reducing costs and developing better products. As the Great Depression illustrates, this strategy is the recipe for a long and severe recession.

What Needs to Be Done?

The keys to sound policy are well-defined property rights, monetary and price stability, open markets, low taxes, control of government spending, and above all, neutral treatment of both people and enterprises. Current policy is way off track. The concept of government as a neutral referee has been destroyed. Today, government is about playing favorites: income transfers, subsidies, and regulations that favor some at the expense of others. Moreover, for all practical purposes, there is now no federal budget constraint. The huge deficits of the George W. Bush administration have destroyed it and political action proceeds as if everything is a free lunch. Costs are ignored and the federal Treasury has become a common grazing ground for business, labor, and other well-organized groups to fleece the taxpayer.

Monetary policy is also in disarray. The Fed is now following a stop-go path much like that of the 1970s. It tried to speed the recovery from the 2001 recession with its low-interest rate policy of 2002-2004. But this led to an increase in inflation. The Fed then shifted to a more restrictive policy in 2005-2006, but this contributed to the burst of the housing price bubble and the recession that started in December 2007. In 2008, the Fed once again shifted to an expansionary policy and by year-end it was expanding the money supply at double digit rates and pushing short-term interest rates to near zero.

As Milton Friedman stressed throughout his career, the problem with stop-go monetary policy is that the time lags accompanying the shifts are long and variable. Thus, the Fed will not be able to time its policy shifts properly and its efforts to stabilize real output and employment will add to their instability. When the Fed tries to affect real variables by shifting back and forth between expansionary and restrictive policies, invariably it will make timing errors and monetary policy will become a source of economic instability. That is where we are now. Predictably, we can expect considerable economic instability as long as the Fed stays on its current stop-go course.

Monetary policy-makers should announce that henceforth they are going to focus on price stability. They will make sure that deflation will not occur; there will be no repeat of the Great Depression. But they should also announce that they will keep the inflation rate low and steady. Thus, neither will there be a repeat of the 1970s. Fed policy-makers should also make it clear that monetary policy works with a substantial lag. Further, because our forecasting abilities are highly limited, it is difficult to tell what economic conditions will be like 12 to 24 months in the future. Thus, the monetary policy-makers should stress that they are going to avoid major monetary swings toward both expansion and contraction because these swings are likely to do more damage than good. Fed commitment to monetary and price stability would be a major step toward getting the economy back on track.

What should President Obama and the new Congress do? First they should make it clear that the policy errors of the 1930s will not be repeated. Trade restrictions and tax increases will not be part of their recipe to get the economy going. They should also make it clear that the era of government favoritism is over. There will be no more bail-outs and subsidies to some firms and sectors at the expense of others. Neither will there be bailouts of some states at the expense of others. Thus, enterprises and state governments had better figure out how to deal with their own problems. Understandably, President Obama may want to proceed with his infrastructure-spending package. To the extent it pays people to produce, it will be an improvement on the Bush policies of sending out so-called stimulus checks. However, the new president should also make it clear that spending is going to be controlled and the federal budget constraint restored.

Is there a Crisis of Markets or a Crisis of Politics?

The Crisis of 2008 is generally perceived of as an economic crisis. Some have charged that it is a crisis of capitalism and market economies. The same thing happened during the Great Depression. The length and severity of the Great Depression were clearly the result of perverse government policies. Nonetheless, the experience increased the role of government and undermined the confidence in markets.

Like the Great Depression, the current crisis is largely the result of perverse policies. Politicians, some well intended but others selfish and corrupt, followed policies and imposed regulations that resulted in at least a trillion dollars of bad loans. Their programs undermined the mortgage lending business and led numerous households into financial troubles. Again, much like the Great Depression, dramatic policy changes, special interest politics, and uncertainty about future policies are retarding market activity and increasing both the length and severity of the current recession.

Paradoxically, the same policy-makers who made a mess of things in the first place are now using more regulation and spending to “fix things” and cover up their prior mistakes. During a crisis, there appears to be a conflict between sound economics and winning politics. Like their counterparts during the 1930s, today’s politicians perceive that they will derive greater political gain from “doing something” even if they have no idea whether what they are doing is helpful or harmful. New programs and aggressive actions project the image of strong policy makers who are trying to “fix” things, and this is likely to be an effective political strategy even if it results in a longer and more severe downturn. This is what happened during the Great Depression and there are ominous signs that we are now headed down this road again. If we choose this path of political allocation, the long-term results will almost surely be more economic instability, stagnation, and even declines in per capita income. (See part 3 of *Common*

Sense Economics for an analysis of problems that arise when resources are allocated through political decision making.)

Suppose we observed a country with regulations that had financial markets in disarray, widespread subsidies to the politically powerful, huge budget deficits, and hastily constructed political action based on doomsday threats. If this were happening in another country, we would recognize that it was the result of a breakdown in political decision-making. If the country had some semblance of a market economy, we would call it “crony capitalism.” Is this descriptive of the United States today?

Suggested Readings

Liebowitz, Stan J., "Anatomy of a Train Wreck: Causes of the Mortgage Meltdown," Ch. 13 in Randall G. Holcombe and Benjamin Powell, eds, *Housing America: Building Out of a Crisis* (New Brunswick, NJ: Transaction Publishers, 2009 (forthcoming)).

Wallison, Peter J. and Charles W. Calomiris, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac", AEI Financial Services Outlook: www.aei.org/publication28704

Wallison, Peter J., "Cause and Effect: Government Policies and the Financial Crisis," AEI Financial Services Outlook: www.aei.org/publication29015

Marginal Definitions

Adjustable rate mortgage. A home loan in which the interest rate, and thus the monthly payment is tied to a short-term rate like the 1-year Treasury bill rate. Typically, the mortgage interest rate will be two or three percentage points above the related short-term rate. It will be reset at various time intervals (e.g. annually) and thus the interest rate and monthly payment will vary over the life of the loan.

Mortgage default rate. The percentage of home mortgages on which the borrower is 90 days or more late with the payments on the loan or it is in the foreclosure process. This rate is sometimes referred to as the serious delinquency rate.

Foreclosure rate. The percentage of home mortgages on which the lender has started the process of taking ownership of the property because the borrower has failed to make the monthly payments.

Investment bank. An institution that acts as an underwriter for securities issued by other corporations or lenders. Unlike traditional banks, investment banks do not accept deposits from, or provide loans to, individuals.

Sub-prime loan. A loan made to a borrower with blemished credit or who provides only limited documentation of their income, employment history, and other indicators of credit worthiness. Federal bank regulators consider loans made to borrowers with FICO scores of less than 660 to be sub-prime. The interest rates on sub-prime loans are generally higher than for loans to prime credit customers.

FICO score. A mathematically-determined score measuring a borrower's likely ability to repay a loan, similar to a credit score. The FICO score takes into account a borrower's payment history, current level of indebtedness, types of credit used and length of credit history, and new credit. A person's FICO score

will range between 300 and 850. FICO is an acronym for the Fair Isaac Corporation, the creators of the FICO score.

Mal-investment. Mal-investment is misguided (or excess) investment caused when the Fed holds interest rates artificially low, encouraging too much borrowing. The new bank credit is invested in capital and projects that are not economically worthy investments in the long run. At some point a correction must occur to cleanse these investments from the system.

Questions for Thought

1. Why did housing prices rise rapidly during 2002-2005? Why did the mortgage default rate increase so sharply during 2006 and 2007 even before the current recession began?
2. What happened to the credit standards (e.g. minimum down payment, mortgage loan relative to the value of the house, credit worthiness of the borrower) between 1995 and 2005? Why did the credit standards change? How did this influence the housing price bubble and later the default and foreclosure rates?
3. If owners have little or no equity in their houses, how will this influence the likelihood they will default on their mortgage? Why
4. When did mortgage default and housing foreclosure rates begin to rise rapidly? When did the economy go into the current recession? Was there a causal relationship between the two? Discuss.

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For additional details, see Peter J. Wallison and Charles W. Calomiris, "The Destruction of Fannie Mae and Freddie Mac" American Enterprise Institute, online, posted Tuesday, September 30, 2008. Also see Common Cause, "Ask Yourself Why . . . They Didn't See This Coming," September 24, 2008, available at www.commoncause.org/site/pp.asp?c=dkLNK1MQIwG&b=4542875 and Center for Responsive Politics, "Lobbying: Top Spenders," 2008, available at www.opensecrets.org/lobby/top.php?indexType=s

3 Joint Center for Housing Studies, *The State of the Nation's Housing 2008* (Cambridge, MA: Harvard University, 2008), 39, available through www.jchs.harvard.edu/publications/markets/son2008/index.htm

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See Robert Higgs, *Neither Liberty Nor Safety*, p. 114.

5 Robert Higgs, *Depression, War, and Cold War*, p. 16.