2

HOUSING AND THE ECONOMY: A NEW PARADIGM?

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Many see activities in the housing and mortgage markets as causes of the current economic malaise and monetary and fiscal policies as a reaction. This article challenges this notion and argues that the current recession, like most prior recessions in history, did not arise because of endogenous problems in the housing sector but rather because of policy interventions that set the housing market up for a fall. The article discusses what this perspective says about the likely path of recovery and the efficacy and necessity of the administration's interventions to spur recovery.

The connection between housing and the economy has always been intimate. For decades, in fact, the housing sector was the channel through which monetary policy influenced the pace of the economy. Today, many attribute the current economic malaise to problems that originated in housing and mortgage markets. Monetary and fiscal policy changes are seen as the consequence, rather than the cause, of the depressed housing market.

This article challenges the notion that this represents a new paradigm in the relationship between economic policy and the housing sector. Rather, I argue that the current recession, like most prior recessions in history, did not arise because of endogenous problems in the housing sector but rather because of policy interventions that set the housing market up for a fall. Along the way, we discuss what this perspective says about the likely path of recovery and the efficacy and necessity of Obama administration interventions to spur recovery.

THE OLD DAYS

In most of the post World War II decades, monetary policy exploited anomalies in banking and mortgage policy to regulate the real economy. If the central bank wanted to slow an overheated economy, it did so by elevating interest rates and, thereby, the cost of mortgage credit. Higher mortgage rates would slow the rate of new home sales and with it, the level of construction activity, appliance sales, and furniture sales. The resulting, sharp reduction in aggregate demand for these products would propagate throughout the economy and slow the pace of income and output growth.

The connection between Federal Reserve policy, housing and the economy was amplified in most of the 20th century by the nature of financial products that banks and savings and loan associations could offer. First, banks were restricted from paying interest on bank deposits. As a consequence, when market interest rates increased, a process known as disintermediation occurred. Depositors would withdraw their funds from non-interest paying depository institutions and buy interest bearing instruments from brokerage firms and government borrowers. With fewer deposits on hand, lending contracted sharply.

Because our banking system, like most modern banking systems, is a fractional reserve system, withdrawal of small amounts of deposits would cause much larger, system-wide reductions in lending as the loss in reserves (vault cash and deposits at the Federal Reserve bank) necessitated reduction in lending by an amount that was a multiple of the deposits withdrawn. This disintermediation channel persisted until innovations in methods of providing checkable access to non-bank balances and, ultimately, the abandonment of Regulation D, reduced the virulence of disintermediation.

The other phenomenon that helped create a channel for monetary policy to influence housing was the nature of mortgage instrumentation and regulation. Specifically, most home mortgages were standard, self-amortizing fixed rate loans. Cycles in interest rates translated directly into changes in mortgage payments on new loans. Adjustable-rate mortgages and mortgages with whose contract rate and amortization features could vary with the interest rate cycle were uncommon. Whereas today mortgage instruments allow payments to grow over time with the households' ability to pay, the standard fixed rate mortgage made access to mortgage credit more difficult during high interest rate parts of the business cycle. Other innovations, such as longer mortgage terms, mortgage insurance, and inclusion of spousal income in loan qualification standards, increased the resilience of mortgage credit flows to interest rate shocks.

By the 1980s, weakened disintermediation processes and more flexible mortgage instrumentation limited considerably the impact of monetary policy on housing and mortgage markets. Coupled with a new Federal Reserve operating strategy introduced under the chairmanship of Paul Volcker, the stage was set for economic growth to be much less volatile than in earlier decades. This is precisely what happened. By the end of the 1990s, journals such as *Foreign Affairs* went so far as to herald the end of the business cycle (Weber, 1997).

GOVERNMENT CAN'T KEEP ITS HANDS OFF HOUSING

The 1980s and 1990s were a period of prosperity, as the high inflation and interest rates of the Carter years were replaced by a steady downtrend in both indicators. Coupled with reductions in marginal tax rates initiated in the Reagan years, the 1980s were particularly prosperous, and prior budget deficits gave way to modest surpluses in the Federal budget. The stage was set for an extended period of prosperity, and growth and stability in the housing sector.

Unfortunately, politicians do not get rewarded for husbanding the status quo. Prosperity allows politicians to believe that they now have the latitude to "do good" by intervening in the way the economy is distributing the resulting economic largesse to its citizens. In particular, the notion of credit "democratization" became a hallmark of Clinton administration banking policy. An old mythology dating from the Carter years was resurrected, and various policies were put in place to address the alleged tendency for mortgage and other lenders to discriminate against protected classes of individuals or certain communities in their application approval processes.

As a result, a series of initiatives were undertaken in the mid-1990s to aid the "democratization" and anti-discrimination initiative and to provide additional tax incentives to home buyers. This included plans to send "testers" (individuals posing as borrowers) into the offices of lenders to see how they were treated, passage of reforms of the Community Reinvestment Act (CRA) to hold banks to the same ratios of loan rejection across races and communities, applying pressure to the secondary mortgage market makers (e.g., Fannie Mae and Freddie Mac) to adopt looser standards in their definitions of conforming mortgages, and the passage of the 1997 Tax Act, that allowed capital gains tax exemption on homes held for as few as two years.

For its part, the investment banking community provided securitization services to help get pools of substandard loans into the hands of investors, thereby channeling funds that fueled the democratization process. Indeed, in 1997, the ill-fated Bear Stearns investment bank was underwriter on the first security backed by Community Reinvestment Act loans. The success of this sale was heralded by the Comptroller of the Currency and other regulators, as were the aggressive efforts by Countrywide Bank and others to market loans to sub-par quality credits.

The cheerleading of junk lending by regulators, the Clinton administration, and community groups was combined with laxer standards and higher leverage permitted at the government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. These GSEs are important secondary mortgage market makers via provision of credit enhancement. In the name of democratization of credit, they tilted credit flows sharply toward home ownership in general, and homeownership by poor credits in particular. These policies began in earnest in the mid-1990s, and their distortionary effect on home ownership rates can be easily seen in the figure below. Homeownership jumped nearly five percent, drawing in many households lacking the job stability and credit-worthiness to take on the burden of home ownership.

DEMOCRATIZATION BITES THE HANDS THAT FED IT

Non-market credit allocation is never a good idea, but it is a particularly bad idea when the distortions are glossed over by the eagerness of social engineers to "do good." Although 1990s housing policy was creating a ticking time bomb of poor credit, few people sounded the alarm. Although there was no mistaking the trend toward junk mortgage lending, attention was not focused on the accumulating risks, but rather the seemingly good things that were happening as a result of the policies. In 1997, in a speech in New York, for example, Eugene

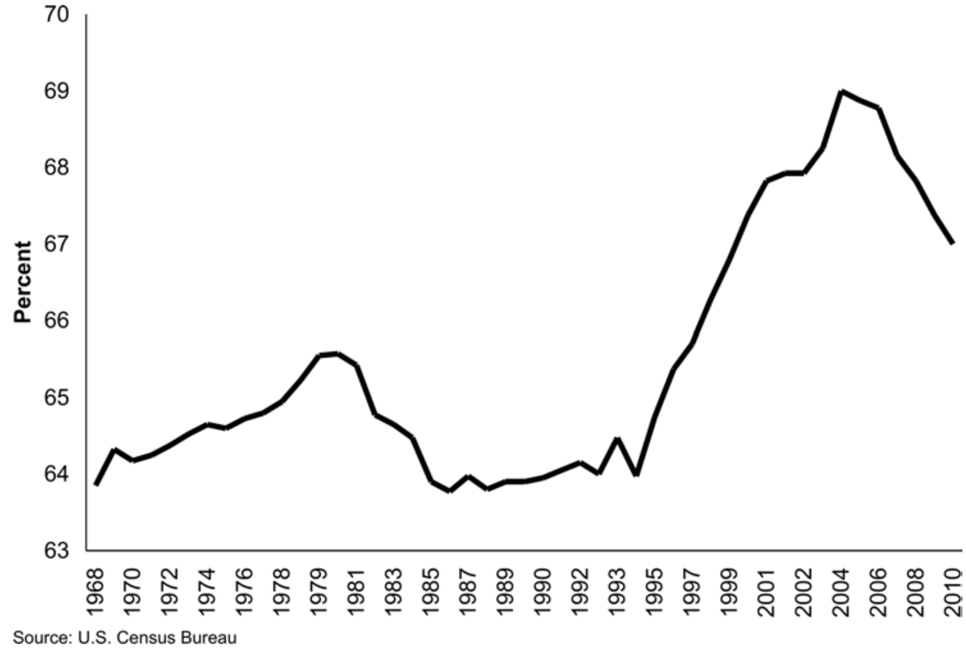

Figure 2.1 The Effect of Mid-1990s Credit Democratization on Home Ownership Rates

Ludwig, Comptroller of the Currency, spoke with pride of the fact that lending to protected classes and communities was growing faster than lending to borrowers with traditional credit profiles.

Liberal economists also let the goals of the policy blind them to the looming risks in the mortgage market. In 2002, Nobel laureate Joseph Stiglitz and Peter Orzag co-wrote an article for Freddie Mac that concluded that the risks to the secondary market and holders of mortgage backed securities were extremely small (Stiglitz, Orszag, and Orszag, 2002):

> The paper concludes that the probability of default by the GSEs is extremely small. Given this, the expected monetary costs of exposure to GSE insolvency are relatively small—even given very large levels of outstanding GSE debt and even assuming that the government would bear the cost of all GSE debt in the case of insolvency.

Indeed, the sprinkling of a bad credit here and there in the loans backing mortgage bonds would not have posed a serious risk to the housing market or the economy. The problem, however, was that events were to unfold at the Federal Reserve Board that sent a synchronized shock throughout the mortgage market.

Specifically, after abruptly drawing back the excess liquidity that it had injected in anticipation of a calamitous Y2K event, the Fed found itself with a recession on its hands. Chairman Alan Greenspan spearheaded a sharp decline in the Federal Funds rate that persisted from 2001 to 2004–05, with the aim of engineering a sharp recovery from the recession. The low rates added further fuel to the distorted mortgage market by increasing the spread between short and long rates. The low short-term interest rate environment also exaggerated the use of adjustable rate mortgages.

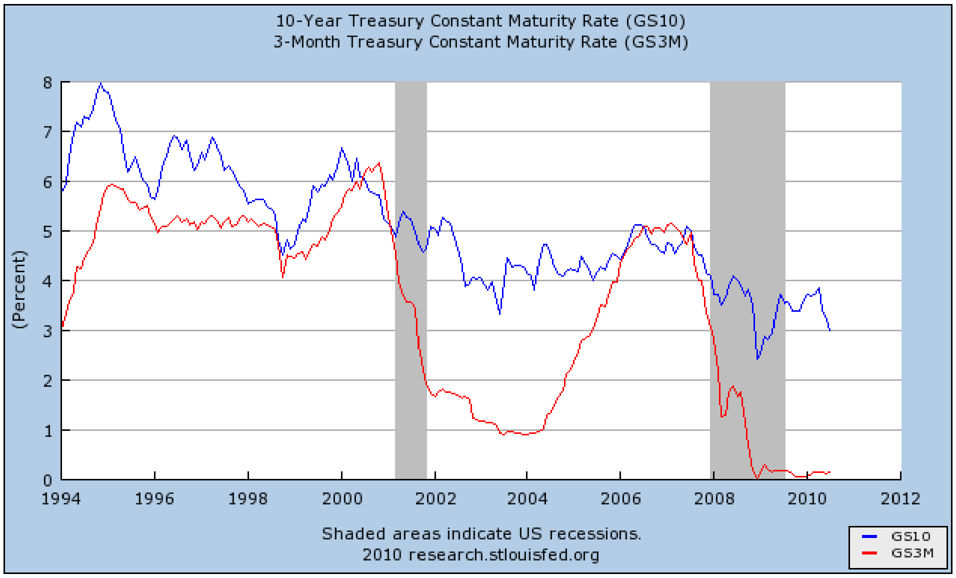

Figure 2.2 The "Greenspan Put"

Home price appreciation accelerated, creating the impression of high returns to housing investment. Capital gains tax reforms policies encouraged short-term ownership and "flipping" of homes to capture the tax-free capital gains appreciation. On top of this, momentum-based investment strategies drew in inexperienced investors who naively thought that such appreciation can go on forever and tend to think that they will be able to bail out of the market before it turns down.

Unfortunately, a combination of rising oil prices and asset inflation lead the Fed to believe that the economy and prices were becoming overheated. In 2004, the Fed abruptly raised rates with a rapid succession of rate hikes totaling nearly five percentage points. The abrupt removal of cheap credit revealed the poor quality credits for what they were. Instead of mortgage bond holders having to absorb losses from a few, random badly made mortgages, the market suddenly faced a systematic, simultaneous deterioration in the quality of the assets backing mortgage securities and lender portfolios.

The diffusion of credit risk among many investors and the "stripping" of mortgages into tranches of varying levels of risk had been thought to be protective in an environment of junk lending. It could not be protective, however, in an environment of systemic risk. The synchronous weakening of investor and bank portfolios everywhere posed a huge threat to the functioning of financial intermediation in a fractional reserve banking world. Financial institutions big and small teetered on the edge.

BAIL OUT MANIA

Few economists question the need for central bank intervention in a setting in which the supply of loanable funds is collapsing exponentially. Financial intermediation is a crucial lubricant of economic activity. Hence, the steps taken by the Fed and the Treasury in the waning months of the Bush administration likely were needed to quell a much more rapid decline in financial activity.

Unfortunately, the new Obama administration chose to take steps that had little prospect of bootstrapping the economy, and most likely aggravated the recession. Specifically, the Obama administration resurrected long-discredited classical Keynesian policies under the guise of "fiscal stimulus." Under this notion, the taking of private resources and spending them in the public sector somehow is supposed to stimulate the economy. In fact, of course, public spending can increase only by either taking current resources from the private sector (through immediate taxation) or by saddling the private sector with debt (i.e., a burden of taxes to be collected later).

In addition to a giant \$870 million fiscal stimulus program, the Obama administration engineered programs specifically targeting the housing sector. Unwilling to let market forces deal with the imbalance in housing supply and ability to pay, the administration crafted dozens of programs to try to keep these inevitable forces from working to restore balance between housing supply and demand.

There are several key features of the policy initiatives. First, there were efforts to encourage banks to renegotiate mortgage terms for those borrowers who, in all probability, should never have been given a mortgage in the first place. Most of these efforts simply prolonged the inevitable, since these borrowers were self-selectively financially naive, lacking in sufficient income or over extended speculators. Hence, the net macroeconomic effect of this program was to delay the adjustment of housing supply and demand to correct the imbalances caused by the earlier, imprudent efforts to democratize credit.

A second key feature was the extension of the Mortgage Forgiveness Debt Relief Act, first passed by Congress at the end of the Bush Administration, but extended through 2012 under the Obama administration. This act removed an important disincentive to a home owner walking away from a mortgage loan. Specifically, under long-standing IRS regulations, if a homeowner walks way from a mortgage, the value of the mortgage left unpaid is considered income to the homeowner and subject to federal income taxes. This policy provides a strong disincentive to letting a home go into foreclosure even if the home's value has fallen below its loan obligation. By removing the tax burden associated with walking away from a mortgage loan, this policy has the perverse effect of accelerating, rather than containing, the pace of foreclosures.

A third policy tried to address the weakened demand for housing by subsidizing (through tax credits) the purchase of homes by first-time homebuyers. Like the "Cash for Clunkers" program in the automobile market, this program's only effect is to create a temporary strengthening in prices, followed by a likely equal or larger weakening when the program is over. Hence, it is yet another program with no prospects of positive effect, but at the cost of further enlarging the deficit.

A fourth policy is so-called financial reform. Policy makers have refused to accept that government intervention in mortgage markets was the precipitating cause of the current hosing market and macroeconomic malaise. Instead, the financial agents that accommodated to these distortions have become the target for blame, and the justification for further government involvement in the marketplace. Instead of focusing on restoration of a normally functioning banking market, policy makers have chosen to focus on creating a diversion from their culpability by lambasting industry participants.

THE FUTURE FOR HOUSING AND THE ECONOMY

In my view, the Keynesian stimulus policy pursued by the Obama administration has done little to restore or preserve economic growth and employment. It has distorted Fed policy by adding long-term debt management challenges to the Fed's already-full plate. It has also increased the temptation to bring down deficits through repeal of the Bush-era tax rate cuts and increases in Social Security and Medicare payroll tax rates.

The Obama administration's "Cash for Clunkers" and first-time homebuyer tax credits have only further served to aggravate the deficit, with little or no net effect on the target markets except to shift purchases in time. Its persistence with, and extension of, the Mortgage Forgiveness Debt Relief Act has very likely amplified the number of homeowners walking away from their mortgage debt. Such an effect would further depress, rather than stimulate, home prices and cause further foreclosures and slow the re-entry of investment in housing.

As Stanford economist John Taylor testified before Congress, cycles in the economy are much more strongly related to investment activity than government spending (Taylor, 2010). Ironically, Obama's own Chair of his Council of Economic Advisors, Christina Romer, concluded in a recent paper published with her economist husband that, indeed, tax cuts, rather than fiscal stimulus with tax increases, is most likely to stimulate economic growth (Romer and Romer, 2010). Thus, the depression of investment caused by the threat of higher tax rates on high-income households and the Administration's perverse approach to the home-price and foreclosure problem continue to threaten recovery.

As two decades of missteps by Japanese policy makers has illustrated, the pursuit of Keynesian policies, enlargement of deficits, and tax rate increases—if continued—will only lengthen economic malaise. The first series of Japanese fiscal stimulus programs (begun in 1991) totaled 21 percent of annual GDP. By way of comparison, ours was 5.5 percent. Add in Japan's subsequent 5.1 percent package in 1998, and it makes one wonder why there remains in the U.S. a call from some for further fiscal stimulus. All such behavior got Japan was a 180 percent debt-to-GDP ratio.

In sum, investment in general, and housing investment in particular, remain important channels of economic growth. Under current policies, unfortunately, we seem bent on delaying the reinvigoration of these channels. ■

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