The Genesis and Danger of the Mortgage Meltdown

Market Perspectives

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Credit and money are among the most beneficial of society's inventions. But like fire, another beneficial discovery, money and credit have to be handled carefully to avoid dangerous flares that destroy, rather than aid, society. Clearly, the recent meltdown of subprime residential mortgages provides an example of how to handle mortgage credit badly and thereby create a potentially incendiary danger to the entire credit market, which could spread to weaken other areas of the economy. The immediate cause of the meltdown was the inevitable result of the widespread substituting of prudent, due diligence-based decision making with high-powered selling techniques that generated big fees for mortgage placements.

There were at least two reasons why society's legislative and executive watchdogs rejected the calls for tighter controls on low-down-payment loans and the issuance of mortgages with low "teaser rates" that hooked borrowers but subjected them to higher rates in the future. Going back as far as 1995, when President Clinton and his Secretary of Housing and Urban Development considered the potential expansion of mortgage credit that came with the securitization of such loans, the possibility of granting mortgages to households with little equity was seen as a necessary offset for the decline in the rate of homeownership likely to result from steadily rising housing prices. Like the college loan programs, which are seen as a way of keeping college affordable to moderate income students, allowing securitized debt to fund home purchases to low asset families was intended to maximize the number of families able to climb into middle class status through homeownership.

The soaring price of housing, which has been increasing for more than half a century, and exponentially so from 1993 to 2005, provided a Pandora's box of motivations for both the boom in the laxity of lending criteria and the reluctance of government to require the tightening of criteria for mortgages made to new home buyers or the refinancing of existing homes. Mortgage and associated real estate brokers saw what appeared to many to be an ever-rising housing price trend and provided a sales pitch that would enable them to increase their earnings from the sale and financing of homes and release of "excess capital" from refinancing. It became hard for any would-be borrower to attend a party at which someone did not brag about the increased value recent years had added to their home; such stories softened up many who would have been better off continuing to be renters, as well as home owners who should have continued to pay off their existing mortgages, to siren calls from mortgage lenders.

The number of financial service providers and borrowers who had become true believers in the ever-increasing price of housing increased dramatically. One gauge of the expansion in the employment within the financial service industry is the decline of 40,000 jobs in that industry so far this year. As long as the belief in ever-rising prices held sway over a considerable portion of the public and those they elected into their government, the temptation to use the power of government to put a lid on the expansion that had been taking place in this industry was easy to resist.

But throughout this period, there were some who predicted that house prices could not continue to rise forever. Professor Robert J. Shiller, the author of *Irrational Exuberance*, was a leader among this group. He continues to argue that the housing price increases we have seen in the recent past are merely the upside of a cycle, and that we are now at the beginning of the downward slide of that cycle. As he wrote August 26th in a *New York Times* column, "Rising prices encourage investors to expect more price increases, and their optimism feeds back into even more increases, again and again in a vicious cycle." While Shiller's account explains why both sides accepted mortgage deals as housing prices rose and mortgages became riskier, it misses why housing prices themselves continued to escalate.

The explanation for the long and ever-increasing price trend relates more to fundamental economics than it does to psychology. When prices go up faster than costs, the expectations of profits rise and, where possible, that brings forth increased supply. But since the 1970's, changes in both public laws and attitudes have created a barrier to such increases in the housing supply. Whether we call them growth regulations, anti-sprawl policies, agricultural preservation or citizens' participation, the policies of land use planning in many economically fast growing regions have greatly slowed the expansion of housing supplies on farmland in the suburbs and on obsolete infill sites in many cities. It was the result of those policies that set up the mortgage plays we now look back on critically. Avoiding a repeat of the mortgage problems now upon us requires more than a tightening of credit laws. It also calls for a hard look at the land use policies of the many economically strong regions where public land use entitlements outweigh market factors in shaping the ability of builders to add units to the supply of housing.

While they are hard on the individuals involved, the foreclosures on borrowers unable to meet the terms of their subprime loans constitute only a small portion of the housing market in most locations. But when one portion of the credit market begins to fail, the danger is that the pull back of money and activity in that subsector will spread to other sectors of credit and behind credit into the "real" economy. That is what the Federal Reserve has tried to avoid by dropping the price they charge member banks borrowing funds through the Fed's discount window. If the credit squeeze does tighten as lenders overreact to the subprime loan meltdown, the Federal Reserve will have to take further action.

One hundred years ago, the United States went though what was referred to as "the panic of 1907." From May 1907 to June 1908 there was a sharp drop in output. Employment dropped about 11 percent as the banking system contracted loans and even refused to pay back some deposits. The decline came to an end when George Cortelyou, Secretary of the Treasury, deposited $25 million with the chief central reserve city banks in New York City and industrialist J.P. Morgan organized a private pool with an equal amount to enable the New York banks to meet the demands of their depositors, who had started to run to the banks to withdraw all their funds. With calm created by Cortelyou and Morgan came the resurgence of the economy, ushering in a period of relative prosperity starting in late 1908.

If the Federal Reserve Bank continues to play its hand carefully and other factors outside the credit markets -- such as the possibility of another bad hurricane season or disruptions in our labor markets through the sudden enforcement of laws against the employment of undocumented aliens -- don't add to the economic stress of the current mortgage problems, the sub prime meltdown of 2007 will end like the panic of 1907.