Don't Rock the Boat: How Residential Mortgages Changed the Economic Landscape
Trends
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For most Americans, home ownership would not be possible without the availability of credit. In the fall 2005 issue of *The Journal of Economic Perspectives*, Professors Richard K. Green and Susan M. Wachter review the uniquely U.S. system of home mortgages. They describe recent innovations that are very important in explaining increases in home ownership during a period of rising house prices. The mortgage options offered and their funding by global securitization have done much more than support the expansion of the construction industry; they have also provided a conduit whereby global sources can lend their capital to support U.S. households' purchases of a broad variety of consumer goods, as well as housing.

The upward swelling of capital into the hands of borrowers pushes up economic growth in the borrowing country. Such growth is sustainable, however, only if the flow of credit does not suddenly contract. People with long memories worry about such an eventuality because the collapse of the mortgage markets was one of the contributing causes of the Great Depression. As Green and Wachter point out, "...in the early 1930s, property values in the United States declined by 50 percent relative to peak values." The economy probably would have only gone into recession if housing's plunge off the economic boat had been at least partially offset with vigorously expansive fiscal and monetary policy.

The Hoover administration reacted to the crisis of a shortfall in revenue by trying to hold down governmental expenditures, and the reaction of the Federal Reserve Board was equally counterproductive. Between 1929 and 1933, the money supply declined by one-third, according to *Monetary History* by Milton Friedman and Anna Schwartz. During the free fall of the economy during Great Depression, 10 percent of all homes were in foreclosure. As lending institutions dumped foreclosed property on the market in a mostly vain attempt to save themselves, the price of housing joined the free fall.

The reform of the mortgage system initiated as a part of Roosevelt's "new deal" was geared to enabling borrowers to better weather price declines without having to default, and better shield lenders from illiquidity. Before the 1930s, the typical U.S. mortgage was a five- to ten-year uninsured "bullet" loan. Borrowers were in trouble if they defaulted or were unable to renew. Lenders could foreclose, but with lots of unsold homes on their balance sheets, they could find themselves unable to meet depositor obligations.

A system of federally-backed insurance mitigated the problem of lender illiquidity. The replacement of the bullet with a 20-year or longer self-amortizing loan lessened the default danger to borrowers. Although these major inventions of financial engineering did a good job of improving the safety and reliability of the system, they did little to resurrect home construction. Residential construction during the Great Depression was about a one-tenth of what it had been in 1925.

Housing development stayed in the doldrums until the end of the World War II. By that time, the government had recognized that facilitating the expansion of mortgage credit was a tool for expanding housing production, not only a device to minimize foreclosures and protect lenders. The G.I. Bill of Rights allowed returning veterans to get inexpensive mortgages with low down payments. The system worked will until the 1960's, when deposit institutions that played a major role as mortgage lenders found themselves unable to hold the deposits they needed to back mortgages.

The resulting changes to the system encouraged securitization as a source of funds for mortgages and the growth of private mortgage insurance. Securitization enabled investors all over the world to buy a piece of packaged, long-term U.S. residential mortgages. Fortunately, from the viewpoint of economic safety, most mortgages continue to be fixed-rate, long-term, self-amortizing vehicles; however, a great variety of shorter-term, fixed- and floating-rate mortgages with alternative amortization periods and down payment requirements are now being offered.

Securitization and the availability of more liberal lending options have enabled mortgages to offset the effect of rising prices on ownership.

Almost 44 percent of American households owned their own home in 1940. That figure is close to 69 percent today. Mortgage debt grew from 20 percent of total household income in 1949 to 73 percent in 2001. Green and Wachter's article shows that mortgage debt has grown from about 13 percent of GDP in 1950 to 69 percent in 2005.

We can expect the U.S. economy to continue to expand as long as our economic boat is not rocked by either of two things. First, our fiscal and monetary authorities must take care to keep spenders and lenders from rushing to the same side of the boat at one time. Second, asset holders all over the world must keep returning dollars to the United States to fund mortgages and other debt and equity vehicles. If home prices begin to stabilize or slow their rate of ascent, the importance of these two factors for continuing prosperity will be lessened.

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