The Levy Economics Institute of Bard College

Public Policy Brief

Highlights, No. 95A, 2008

HIGHLIGHTS

SHAKY FOUNDATIONS

Policy Lessons from America's Historic Housing Crash

PEDRO NICOLACI DA COSTA

Introduction

Once touted as a foolproof investment, America's spectacular housing crash has tarnished the mortgage sector and sent the economy into disarray. The slump has also rendered untenable the Federal Reserve's (Fed) claim that bubbles are impossible to spot ahead of time (Greenspan 2007), since the signs of speculative excess have long been evident in housing. In retrospect, it has now become abundantly clear that there was plenty the Fed could have done to discourage speculative behavior and put a stop to predatory lending.

A key flaw in the Fed's approach to bubbles is that it is asymmetric—it leaves markets to their own devices as asset prices inflate, and then is forced to overreact through sharp monetary easing and aggressive intervention. In this sense, the Fed and other central banks already target asset prices. Yet, by taking aim at them only on the way down, the "Big Banks" create a self-perpetuating cycle of perverse incentives and moral hazard that often gives rise to yet another round of bubbles.

Asset bubbles have become increasingly obvious. Former Fed Chairman Alan Greenspan spotted the stock bubble well in advance of its peak, famously accusing the markets of "irrational exuberance" in 1996. Moreover, the housing market crash has been a train wreck in slow motion. The warning signals, such as price charts showing home values rising impossibly into the stratosphere and Wall Street's increasing reliance on housing-backed bonds for its record-setting profits, were ubiquitous.

The full text of this paper is published as Levy Institute Public Policy Brief No. 95, available at www.levy.org.

The Levy Economics Institute is publishing this brief with the conviction that it represents a constructive and positive contribution to the discussions and debates on the relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the author.

Copyright © 2008 The Levy Economics Institute

ISSN 1094-5229 ISBN 978-1-931493-79-6

Recent U.S. experience has bolstered the view that asset prices must become part of the central bank's purview in order for the economy to retain some semblance of stability. Former Fed Chairman Paul Volcker (2008) recently called for a broader regulatory role for the central bank in light of the housing-centered credit crisis. Treasury Secretary Henry Paulson's plan for tackling the crisis involves giving the Fed vast new authority to regulate investment banks, not just depository institutions. However, this paper will argue that attitude changes among regulators will be even more important than shifts in mandate in ensuring that regulators like the Fed do their jobs properly.

Innovation, Exploitation

Because of the dominant presence of banks in the media, the story of the current crisis is often told from the point of view of the lender. But for policy purposes, it is important to keep in mind the other side of the ledger: the borrower. In the housing debacle, dubious lending habits were labeled as "innovation" that would improve access to credit for the underclass. The Federal Reserve fully bought into this line, and promoted the idea. In reality, however, subprime lending actually put housing out of reach for many poor and middle-class Americans, by driving prices far above what could be justified by the simple mechanics of supply and demand.

There is a fine line between ranking credit risks and exploiting the poor. In a strictly hands-off regulatory system, the former inevitably morphs into the latter. This is what has happened in the United States. The greatest expansion of credit in modern history was ultimately regressive, because it trapped its poorest and most fragile recipients in a vicious cycle of personal indebtedness that will take years, if not decades, to unwind. Consumer credit outstanding, currently at $2.5 trillion, now represents nearly one-fifth of gross domestic product. This problem will require proactive solutions by an engaged federal government.

The Fallacy of Affordability

The greatest misconception surrounding the emergence of the subprime mortgage sector is that it was a natural extension of the dream of American ownership. The reality was that subprime loans made housing *less* affordable by artificially inflating home prices and putting a home out of reach for many poor and middle-class Americans. And for households managing to secure a mortgage, the pricing and interest rate structure was ultimately prohibitive, leading to foreclosures that have reached crisis levels.

What is striking from a policy standpoint is that the Fed actively encouraged speculation by touting the advent of real estate derivatives as yet another milestone in "financial innovation." Ironically, this overwhelming nod of approval was taking place even as Fed Chairman Ben Bernanke (2007) admitted that the securitization process was diminishing the central bank's ability to influence the housing sector through interest rate policy.

Indeed, the Fed already had broad oversight over much of the banking sector and yet failed to exercise it, in large part because of an ideological aversion to government's meddling in the business of financial markets. But it was this very skepticism of regulation that laid the groundwork for much of the chaos that has ensued (da Costa 2008, Mayer 2008).

What Bubble?

Following Greenspan's lead, Fed officials have adamantly argued that the central bank cannot and should not target asset bubbles. In denying their existence, policymakers actually encourage speculative extremes by sending the signal to investors that the Fed believed rising asset prices, whether in stocks or housing, were justified. Greenspan knew the U.S. stock market was heading for trouble during the 1990s, and yet apart from a signal nod to market exuberance in the middle of the decade, he eventually embraced such fads as the "new economy" and the "productivity miracle" that ultimately proved misguided. In housing, too, policymakers looked the other way despite ample evidence of excesses, including unprecedented price growth.

Fed policy goals, unlike those of some of their overseas counterparts, include both low inflation and maximum sustainable employment. This dual mandate makes U.S. central bank officials especially cautious about compromising an expansionary trend. Yet the call for policymakers to begin paying closer attention to asset price bubbles should not be interpreted as a vote for concrete asset price targets, which would surely have destabilizing macroeconomic repercussions.

Instead, improved regulatory oversight would enhance the ability of policymakers to fend off financial instability before it reaches crisis levels and threatens to engulf the entire system. Globally, a growing number of central bankers—including

those in England, Norway, Canada, and New Zealand—have also supported "leaning against" bubbles by gently tapping on the monetary brakes when signs of trouble begin to appear (Cardarelli, Igan, and Rebucci 2008).

American Mavericks

U.S. policymakers have become increasingly isolated in their call for unequivocally rejecting asset prices as a driver of policy. The U.S. economy offers perhaps the best case study for why bubbles should remain in the crosshairs of monetary officials if the transmission mechanism is to remain effective.

Until recently, the United States was the quintessential success story in this area, with the equity from rapidly rising home values lining the pockets of millions of middle-class families and underpinning the greatest uninterrupted spending boom in more than 50 years. But recent developments have highlighted the dark side of this vaunted American dream.

The housing sector is inextricably linked to debt, and the desire to squeeze every last ounce of profit out of America's home-buying bonanza has ended in tears. Those actually crying are the families who were swindled into loans they could not afford. The banking sector, too, is smarting from its own gluttony, feeling the pinch from the mortgage mess in the form of multibillion-dollar losses. The impact of the housing slump on financial institutions is likely to have profound implications for economic growth in coming years, if not decades.

Under Greenspan's leadership, the Federal Reserve quietly abandoned its role of detached economic arbiter and became more of a cheerleader, putting its stamp of approval on the "financial innovation" that turned out to be little more than a Ponzi scheme of leveraged financing. Even as the housing bubble neared its apex, Greenspan (2005) played down its existence and possible adverse effects. The Fed also failed to raise any red flags regarding the reactive nature of credit rating agencies that allowed for the broad spreading of subprime securities. During his 18-year tenure, Greenspan's ultimate fear was that he would be seen as the party-spoiler. Ironically, this very reticence has earned the former Fed chairman his place in modern economic history as the man who presided over the most reckless debt binge in history.

Words: Mightier Than Rates

Not only did the Fed not flex its regulatory muscle in anticipation of the subprime mess, but it also failed to employ what is arguably its most effective policy tool: the power of persuasion. Rather than talking down the frothy housing and mortgage bond sectors, the Fed touted them as beacons of cutting-edge financial progress, tools that successfully allowed for the spreading of risk, thereby raising the amount of capital available for investment.

A more vocal Fed would have had an immediate dampening effect on the market, effectively preempting any need for emergency measures. The central bank could have sent a clear signal to those involved in the mortgage arena that egregious acts of deception and fraud would be highly scrutinized, and not the least bit tolerated.

One of the Fed's most salient failures as a regulatory body—and ultimately as a law enforcement agency—was its willingness to jump on the bandwagon of financial booms without scrutiny or independent analysis. The central bank repeatedly stated that the ability to securitize things like mortgages and car loans, by "spreading risk," would ultimately prevent the emergence of a crisis.

The Fed had no business promoting securitization—its job, in fact, was to be suspicious of newfangled financial products that even Wall Street investors had a difficult time explaining. In doing so, the central bank gave a runaway process of credit creation its unequivocal approval, becoming a de facto enabler of excess risk taking and, in many instances, fraud (Black 2008).

Self-Imposed Limitations

One of the Fed's primary arguments as to why it was unable to stem the boom-bust of housing is the so-called "shadow banking system," where enormous capital flows from investment banks and hedge funds were not legally controlled by policymakers. However, this argument is difficult to accept, if for no other reason than the Fed never lamented this lack of regulatory authority until after the crisis was already well under way (Geithner 2008). Had it done so, such explicit attention might again have acted as a moderate drag on a sector that looked to be getting out of hand—just the sort of low-impact approach, incidentally, that policymakers have suggested they favor.

The Rising Toll of Bubble Madness

The U.S.-led cycle of bubbles, whose global impact has been increasing over the past two decades, seems far from over. The housing and credit crises have forced the Fed not only to slash interest rates sharply, but also to pump billions of dollars into the financial system. However, there is ample evidence that these measures are already leading to speculative excesses elsewhere.

The latest boom is taking place in an area that is likely to exact an even greater toll on the more fragile pockets of the consumer population: commodities. The Fed's actions on both rates and liquidity have exacerbated the U.S. dollar's precipitous descent. But in the process, the agency has also lifted the price of oil, gold, and other commodities to unprecedented heights. This is the acumen of regressive central banking, because the rise in these prices has an immediate and discernible effect on some of the most vulnerable sectors of the population, in the form of spikes in the cost of nondiscretionary goods like food and fuel.

The Next Bubble May Be Deadly

Those looking for proof that bubbles have become increasingly easy to spot in a highly levered financial world need look no further than this year's spike in commodity costs. Oil prices brushed up against $150 a barrel before making a sharp reversal; gold raced past $1,000 per ounce before its own turnaround, and other metals followed much the same trend. Yet the severity of these developments pales in comparison with what was arguably the most dangerous bubble of all: food. The price of everything from wheat to soybeans skyrocketed just as the U.S. credit crisis began, leading to food shortages and riots in several of the world's poorer nations. In this perverse manner, the industrial world's gluttonous appetite for credit and consumption has deprived some of the most vulnerable populations on the planet of basic (and scarce) resources.

In a global financial marketplace, these trends simply cannot be isolated from the policies of the world's top monetary authorities (Rojas-Suarez 2008). Massive cash injections from the Fed, the European Central Bank, the Bank of England, and others visibly funneled a new burst of liquidity into the commodities sector. Moreover, U.S. citizens are in fact already paying a price, not only because of what now looks like an inevitable recession, but also due to budding inflation pressures that many fear will persist over the next few years. Even a brief run-in with food shortages should be enough to illustrate a basic point: inflating and reflating asset bubbles is no way to run a stable economy in the long run.

Overcoming Regulation-phobia

America's housing crisis is the emblem of a pervasive ideological aversion to regulation that has culminated in a Wild West approach to the business of lending. In this environment, the world's preeminent financial firms were all complicit in engaging in highly levered speculation in areas that showed clear signs of overvaluation.

The industry's incentive structure was such that a pressure to produce ever more massive quarterly profits became a primary guiding principle of decision making. Upper management was insulated from personal financial losses, and structured financial products were the securities du jour. The actions of top executives became so deeply detached from the long-term interests of their respective firms, in fact, that banks continued to chase these securities even as their value plummeted, like reckless gamblers chasing losses at a casino table (Krugman 2007).

Just months before the credit crisis erupted, Bernanke (2007) went on the record defending deregulation and warning against the possible toll of enhanced rules. Believing in the self-correcting power of markets, Greenspan, Bernanke, and their colleagues allowed market forces to run their unfettered course, with disastrous consequences for the U.S. and global economies.

Red Tape or Rule of Law?

Over the past three decades, the very concept of regulation has undergone an ideological assault. Yet regulation should not be equated with red tape. A sound regulatory structure provides a basic code of conduct that actually enhances the business of finance, by surrounding it with a sense of confidence and stability. It also makes sure businesses operate within the broader social interest. In reality, a basic framework for proper behavior endows businesses like finance with a sense of legitimacy—just what is sorely lacking under current conditions. Despite some internal resistance, the scope of recent troubles and the prospect of an even deeper slump create opportunities for change. Taken together, the sheer severity of the crises in housing and credit might slowly nudge the Fed toward a more hands-on approach.

Uncentral Bank: The Implications of Eroding Confidence

The Fed has greatly diluted its own relevance by embracing the role of financial cheerleader. By warming up to the notion that asset bubbles pose an a priori danger to economic and financial stability, the Fed would go some way toward reversing the lack of confidence in its ability to stabilize the U.S. economy. This is crucially important, since a weaker Fed could lead to a reinforcement of market excesses that are now pushing the global economy into recession.

The magnitude of the current housing and debt crises offers a unique opportunity for the Fed to reconsider its long-held view that bubbles should remain outside the policy radar. With losses totaling over half a trillion dollars (a tally the International Monetary Fund has estimated may double when all is said and done) and the economy facing the possibility of an unusually severe recession (Krasny 2008), the time has indeed become ripe for a revaluation of the central bank's approach.

Beyond the realm of monetary policy, the need for better regulatory tools employed in conjunction with a vigilant monetary mechanism have found growing acceptance in both scholarly and policy circles (Borio and White 2004). Bernanke (2008) himself has called for an overhaul of the country's fragmented regulatory structure in recent congressional testimony.

Ultimately, prudent policies will only come from policymakers who have honed their regulatory antennas in such a way as to both spot asset bubbles and address them. In a global economy where constant and rapid growth is viewed as an unequivocal good, this may be a difficult approach to implement. But as the U.S. housing and financial crises so clearly indicate, central bankers who accept self-policing as a basis for sound regulation are setting the global economy up for a real disaster.

References

Bernanke, B. S. 2007. "Housing, Housing Finance, and Monetary Policy." Speech. Economic Policy Symposium of the Federal Reserve Bank of Kansas City, Jackson Hole, Wyo., August 31.

———. 2008. "Addressing Weaknesses in the Global Financial Markets: The Report of the President's Working Group on Financial Markets." Speech. Virginia Global Ambassador Award Luncheon, World Affairs Council of Greater Richmond, April 10.

Black, W. K. 2008. "Why Greenspan's and Bush's Regulatory Failures Allowed a 'Criminogenic Environment.'" Speech. 17th Annual Hyman P. Minsky Conference, The Levy Economics Institute of Bard College, Annandale-on-Hudson, N.Y., April 18.

Borio, C. E. V., and W. R. White. 2004. "Whither Monetary and Financial Stability? The Implications of Evolving Policy Regimes." BIS Working Paper No. 147. Basel, Switzerland: Bank for International Settlements.

Cardarelli, R., D. Igan, and A. Rebucci. 2008. "The Changing Housing Cycle and the Implications for Monetary Policy." Chapter 3, *World Economic Outlook: Housing and the Business Cycle*. World Economic and Financial Surveys Series. Washington, D.C.: International Monetary Fund. April.

da Costa, P. N. 2008. "Will, Not Mandate, Needed for Better Bank Oversight." Reuters, April 6.

Geithner, T. F. 2008. "Actions by the New York Fed in Response to Liquidity Pressures in Financial Markets." Congressional Testimony. U.S. Senate Committee on Banking, Housing, and Urban Affairs, Washington, D.C., April 3.

Greenspan, A. 2005. "The Economic Outlook." Congressional Testimony. Joint Economic Committee, U.S. Congress, Washington, D.C., June 9.

———. 2007. "The Roots of the Mortgage Crisis." Editorial. *The Wall Street Journal*, December 12.

Krasny, R. 2008. "U.S. Faces Severe Recession: NBER's Feldstein." Reuters, March 14.

Krugman, P. 2007. "A Catastrophe Foretold." Editorial. *The New York Times*, October 26.

Mayer, M. 2008. "The Fed Has Power, But No Will." *Barron's*, April 14.

Rojas-Suarez, L. 2008. "The Right Response in Latin America to Oil and Food Price Pressures: Fight Inflation Now!" Issue Brief No. 16531. Washington, D.C.: Center for Global Development. August 15.

Volcker, P. A. 2008. Credit Crisis Panel, Harvard Club, New York, April 9.

About the Author

Pedro Nicolaci da Costa has been covering the economy and financial markets for a top international news agency since 2001. His work focuses on a wide range of issues, including monetary policy, the labor market, and major macroeconomic trends. He holds an M.A. in international relations from the University of California, San Diego, and a B.A. in sociology from the University of Chicago.

Recent Public Policy Briefs

Shaky Foundations
Policy Lessons from America's Historic Housing Crash
PEDRO NICOLACI DA COSTA
No. 95, 2008 (Highlights, No. 95A)

Financial Markets Meltdown
What Can We Learn from Minsky?
L. RANDALL WRAY
No. 94, 2008 (Highlights, No. 94A)

Minsky's Cushions of Safety
Systemic Risk and the Crisis in the U.S. Subprime Mortgage Market
JAN KREGEL
No. 93, 2008 (Highlights, No. 93A)

The U.S. Credit Crunch of 2007
A Minsky Moment
CHARLES J. WHALEN
No. 92, 2007 (Highlights, No. 92A)

Globalization and the Changing Trade Debate
Suggestions for a New Agenda
THOMAS I. PALLEY
No. 91, 2007 (Highlights, No. 91A)

Cracks in the Foundations of Growth
What Will the Housing Debacle Mean for the U.S. Economy?
DIMITRI B. PAPADIMITRIOU, GREG HANNSGEN, and GENNARO ZEZZA
No. 90, 2007 (Highlights, No. 90A)

The Economics of Outsourcing
How Should Policy Respond?
THOMAS I. PALLEY
No. 89, 2007 (Highlights, No. 89A)

U.S. Household Deficit Spending
A Rendezvous with Reality
ROBERT W. PARENTEAU
No. 88, 2006 (Highlights, No. 88A)

Maastricht 2042 and the Fate of Europe
Toward Convergence and Full Employment
JAMES K. GALBRAITH
No. 87, 2006 (Highlights, No. 87A)

Rethinking Trade and Trade Policy
Gomory, Baumol, and Samuelson on Comparative Advantage
THOMAS I. PALLEY
No. 86, 2006 (Highlights, No. 86A)

The Fallacy of the Revised Bretton Woods Hypothesis
Why Today's International Financial System Is Unsustainable
THOMAS I. PALLEY
No. 85, 2006 (Highlights, No. 85A)

Can Basel II Enhance Financial Stability?
A Pessimistic View
L. RANDALL WRAY
No. 84, 2006 (Highlights, No. 84A)

Reforming Deposit Insurance
The Case to Replace FDIC Protection with Self-Insurance
PANOS KONSTAS
No. 83, 2006 (Highlights, No. 83A)

The Ownership Society
Social Security Is Only the Beginning . . .
L. RANDALL WRAY
No. 82, 2005 (Highlights, No. 82A)

Breaking Out of the Deficit Trap
The Case Against the Fiscal Hawks
JAMES K. GALBRAITH
No. 81, 2005 (Highlights, No. 81A)

The Fed and the New Monetary Consensus
The Case for Rate Hikes, Part Two
L. RANDALL WRAY
No. 80, 2004 (Highlights, No. 80A)

The Case for Rate Hikes
Did the Fed Prematurely Raise Rates?
L. RANDALL WRAY
No. 79, 2004 (Highlights, No. 79A)

The War on Poverty after 40 Years
A Minskyan Assessment
STEPHANIE A. BELL and L. RANDALL WRAY
No. 78, 2004 (Highlights, No. 78A)

The Sustainability of Economic Recovery in the United States
The Risks to Consumption and Investment
PHILIP ARESTIS and ELIAS KARAKITSOS
No. 77, 2004 (Highlights, No. 77A)

Asset Poverty in the United States
Its Persistence in an Expansionary Economy
ASENA CANER and EDWARD N. WOLFF
No. 76, 2004 (Highlights, No. 76A)

Public Policy Briefs are published in full-text and highlights versions. Briefs and all other Levy Institute publications are available on the Levy Institute website, www.levy.org.