

**Housing/Mortgage Bubbles
and Economies:
1997-2009 and 1922-1934
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Bubbles are frequent in economic history and in the laboratories of experimental economists.

- **What causes them?**
- **What can spark them?**
- **What can sustain them?**
- **How could the dotcom stock market crash (2001) do no damage to the financial system, while the housing market crash (2006-7) devastated it?**
- **If bubbles cannot be prevented, can their collateral damage be contained?**
- **Any parallels with the Great Depression?**

EXPERIMENTAL PERSPECTIVE:

I Begin by Distinguishing Two Kinds of Markets and their Performance

1. Consumer goods and service markets:

Most final goods and services in the economy **are *not* re-traded**; costs and benefits are realized then repeated over time; think of haircuts, hamburgers and internet services.

- * Performance better in Lab than we economists expected.
- * Price discovery processes are very efficient

2. Asset markets:

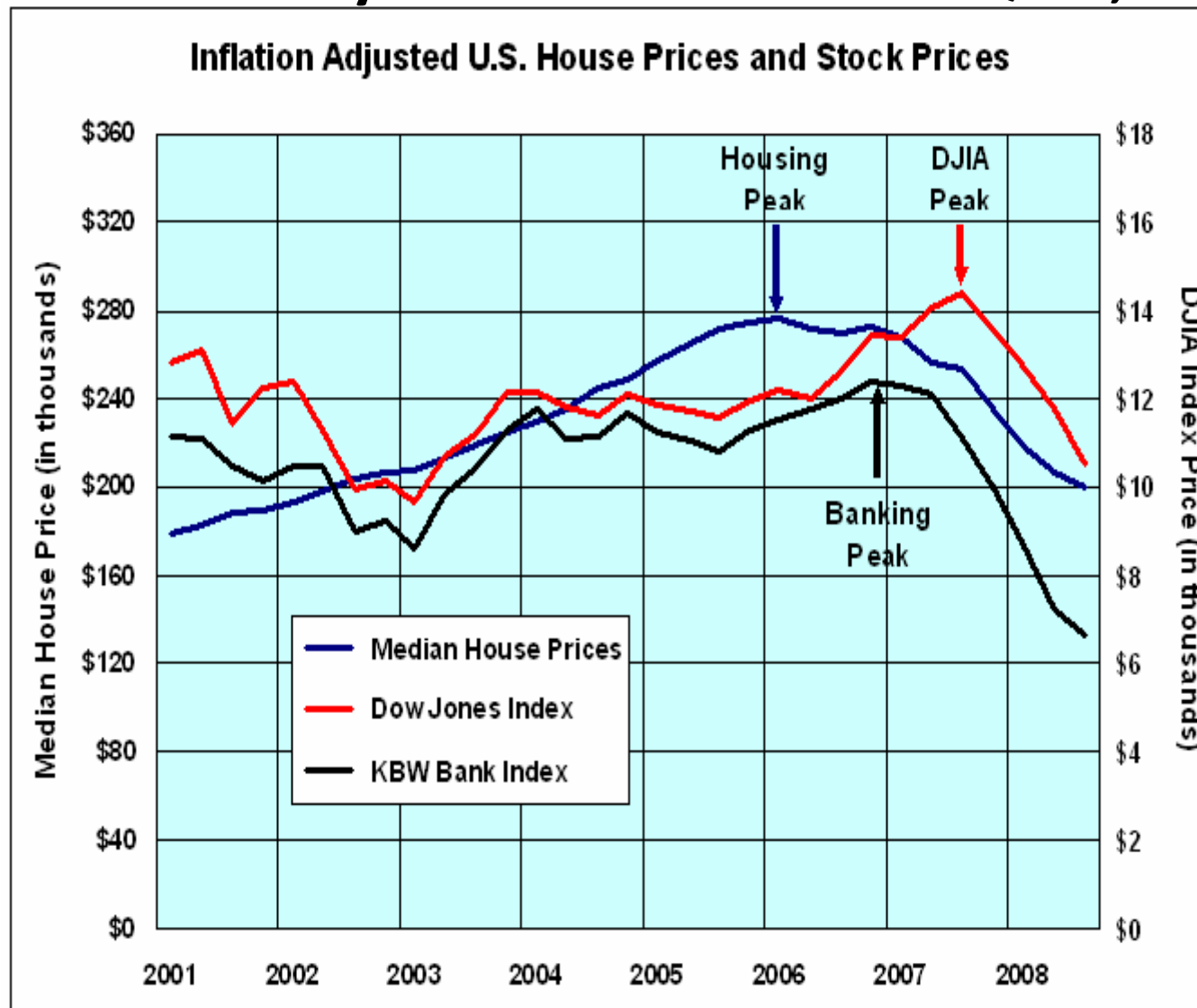
Items like houses, stocks and bonds **are re-traded**.

- * Outcomes in the Lab worse than we economists expected.
- * Price bubbles are common.

Both kinds of experiment results are echoed in the mother of all housing bubbles; its crash spread to banks, then stocks, and finally to a well-functioning consumer-producer economy.

Experts, policy makers, economists were everywhere blindsided: failing to anticipate the crisis.

Chart shows how crisis in housing (2006) spread to banks (2007), then to declines in stocks (Oct 2007). Then the economy entered “recession” Qtr 4, 2007.



• **What is different about asset markets?**

Stocks and homes are bought to hold, or resell, and are subject to price bubbles and crashes.

• Besides fundamental yields, *prices also depend upon how people think others will value them in the future.*

Assets market experiments with student, business, corporate and financial industry leaders, informed of fundamental value, have all produce bubbles; they disappear only with repeat experience.

- Experimental market bubbles are worse if people's initial endowments include more cash relative to shares.
- They are worse if they are allowed to buy shares on margin i.e., borrow to buy shares—credit.
- The Cause? *We do not know why people get carried away with self-fulfilling expectations of rising prices—a bubble.*₅

What sparked the U.S. housing bubble (1997-2000)?

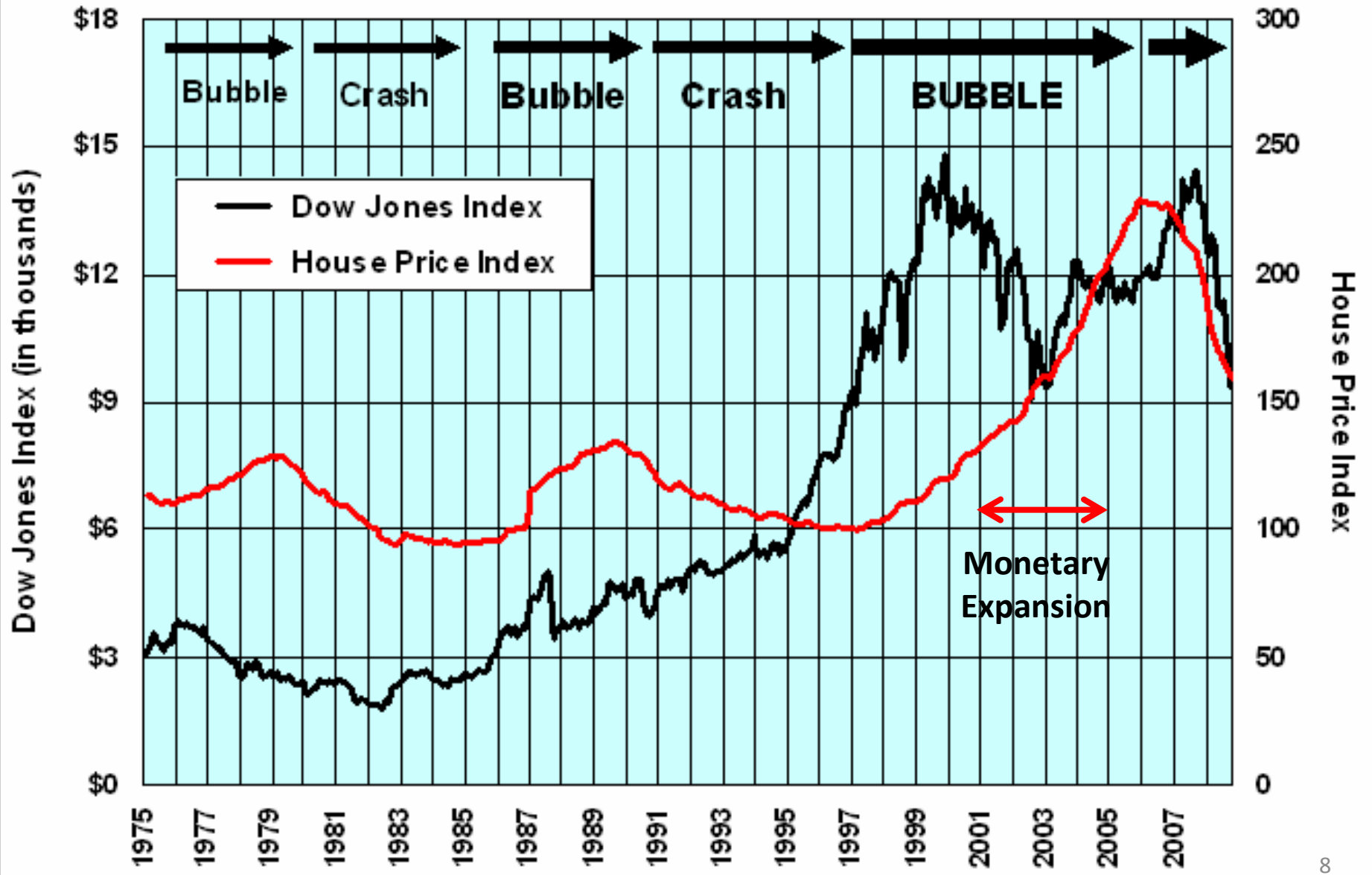
Its not certain, but here are four candidates:

- 1. Laws required performance rating of mortgage-lenders who had to demonstrate efforts to lend to borrowers with incomes below 80% of the middle income. Idea was to help the poor own homes.**
- 2. In 1996, US housing agencies were assigned target goals to direct their funding to low income borrowers; subsequently targets were increased to 50% in 2000, and 52% in 2005. This received bipartisan support from both Clinton and Bush administrations.**
- 3. Taxpayer Relief Act (1997) which exempted home resale (up to \$0.5 million on each sale) from capital-gains taxes.**
- 4. Large US (80% of world total) current account deficit, with resulting large inflow of foreign investment capital early in the 90s**

What may have sustained the housing bubble (2001-2006)?

- 1. Unprecedented ease in monetary policy, 2001-4;**
- 2. Uncollateralized Credit Default Obligations (derivatives)—These were information, not “insurance,” markets. AIG Co. agreed to collateralize if they lost AAA rating.**
- 3. Continued foreign capital inflow.**

Inflation Adjusted U.S. House Prices and Stock Prices



I. Why do stock market bubbles cause minor damage to the financial system?

It's due to collateral (reserve) requirements:

- **Stock purchases are today subject to high cash reserve requirements**
- **Any loan can be “called” by broker if reserve margin is short**
- **Losses are therefore confined predominantly to investors**
- **Banks and non-investors are only secondarily affected**

But it was not always so:

- **Margin collateral requirements (50% and more) emerged in the self interest of private brokerage firms before the crash of Oct., 1929**
- **Then they were adopted by the NYSE for its members, 1933**
- **And finally, were codified by Congress, when the SEC Act (1934) empowered Fed Res to regulate margins (Reg. T, 50%); brokers commonly require higher margins; e.g., C. Schwab 100%.**

Consequently such requirements became an

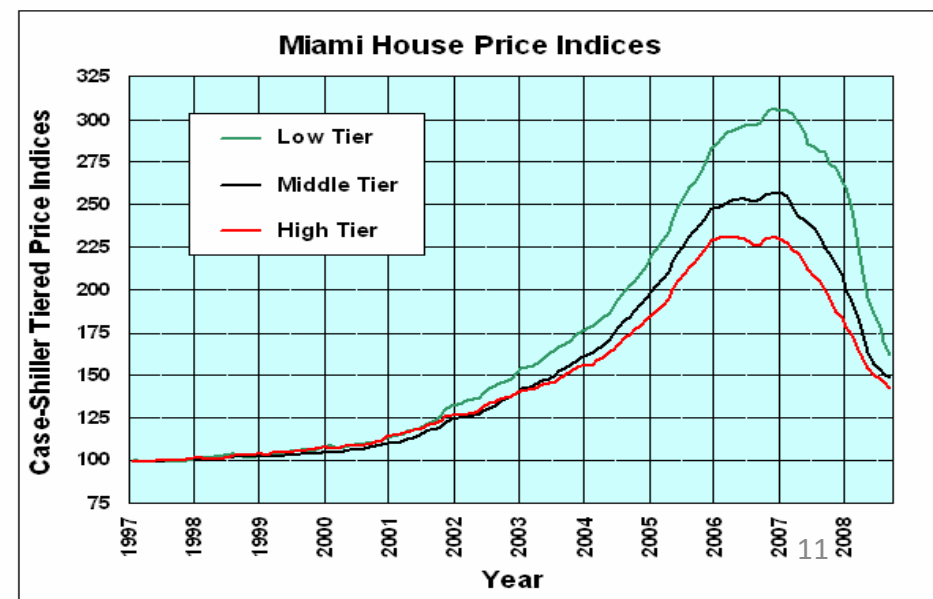
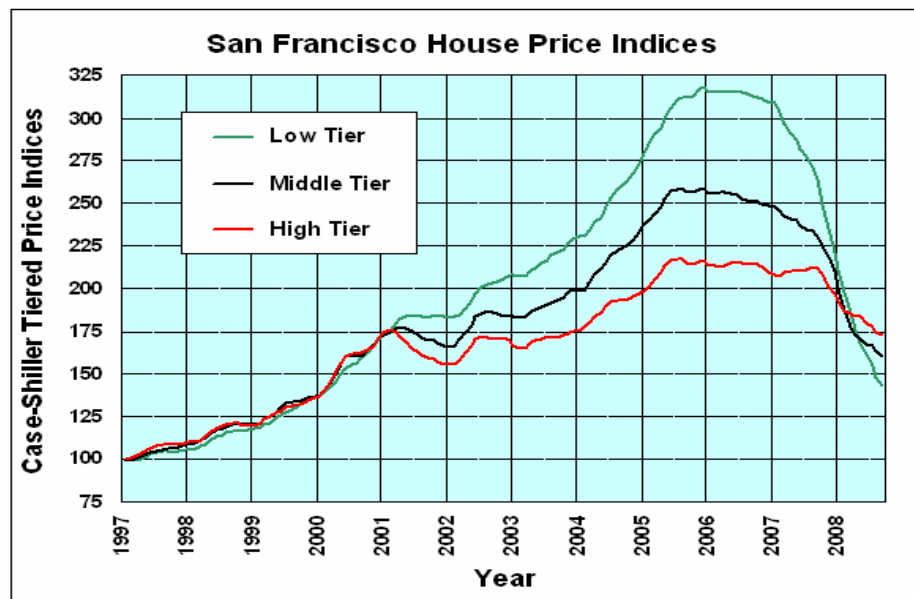
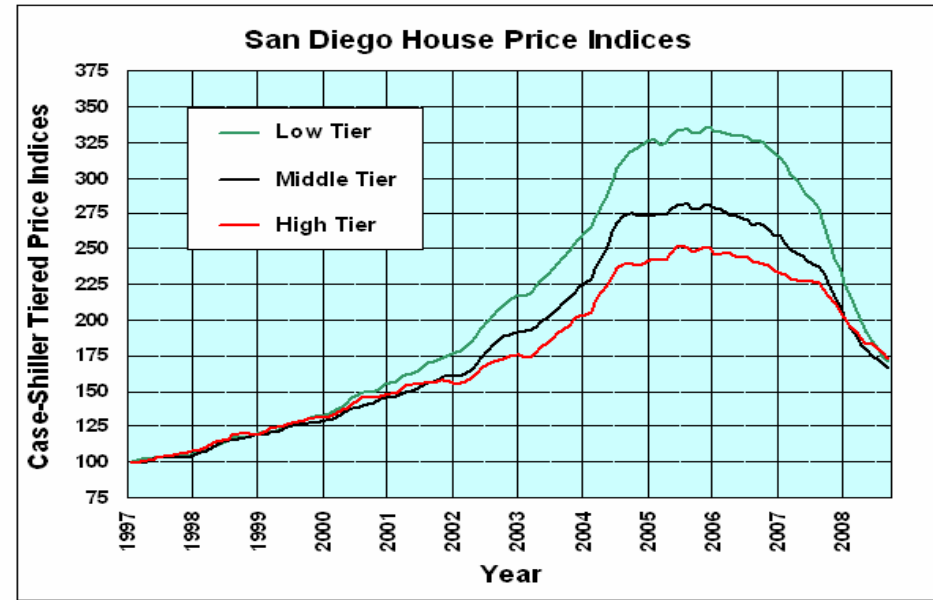
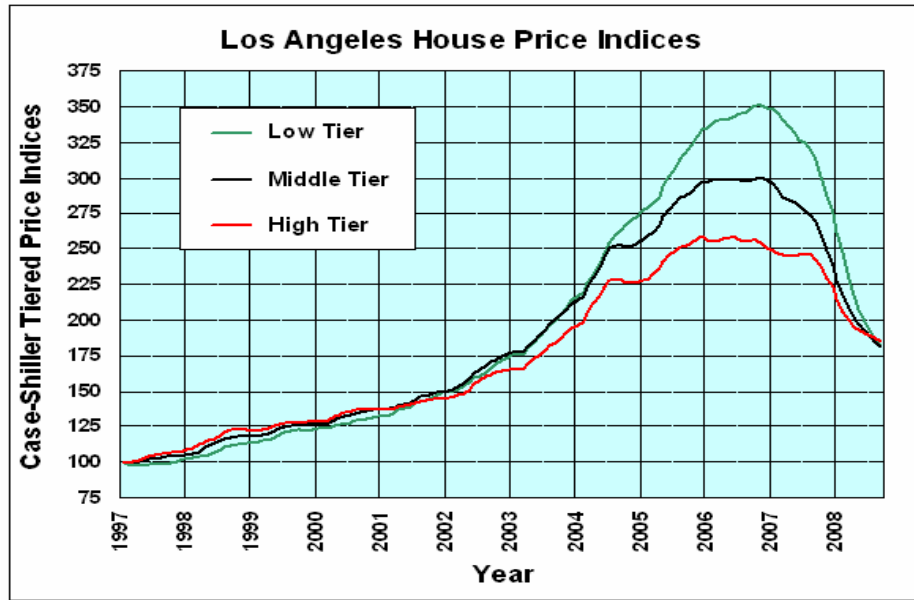
II. Why do housing/mortgage market bubbles devastate financial systems? It's a reserve problem:

- Houses were bought with low cash reserve (“down payments”)**
- Loans are long term and foreclosure is also costly to lenders**
- Losses impact banks, economy, all citizens ,including those who only rent homes, but lose employment because of the economy.**
- Through finance and trade the distress spreads through the world**

It was not always so:

- In the 1920s mortgage loans were like those in the recent crisis: interest only, or with delayed large balloon payments.**
- Corrective response in the 1930s was to require larger down payments, loan amortization.**
- This learned tradition was lost, 1997-2006, with the creation of mortgage backed securities, thought to facilitate home ownership by those of modest income; safety was sought via derivatives, believed to protect against default.**

Impact on the poor? The Cheaper the House the worse the bubble; in the crash, the greater the impact on bank losses



Role of Credit Default Obligations (Derivatives)

In 1998 CFTC Chairperson Brooksley Born issued a concept release calling for revisiting the exempt status of derivatives; “exempt” meant not listed and subject to margin requirements —this action was opposed by Fed Res, Treasury and SEC.

In his July 30, 1998 congressional testimony, Deputy Secretary of the Treasury Lawrence Summers argued, that *“the parties to these kinds of contract are largely sophisticated financial institutions that would appear to be eminently capable of protecting themselves from fraud and counterparty insolvencies.”* (This Market Collapsed in 2007) Legislation (blocking such CFTC action) passed:

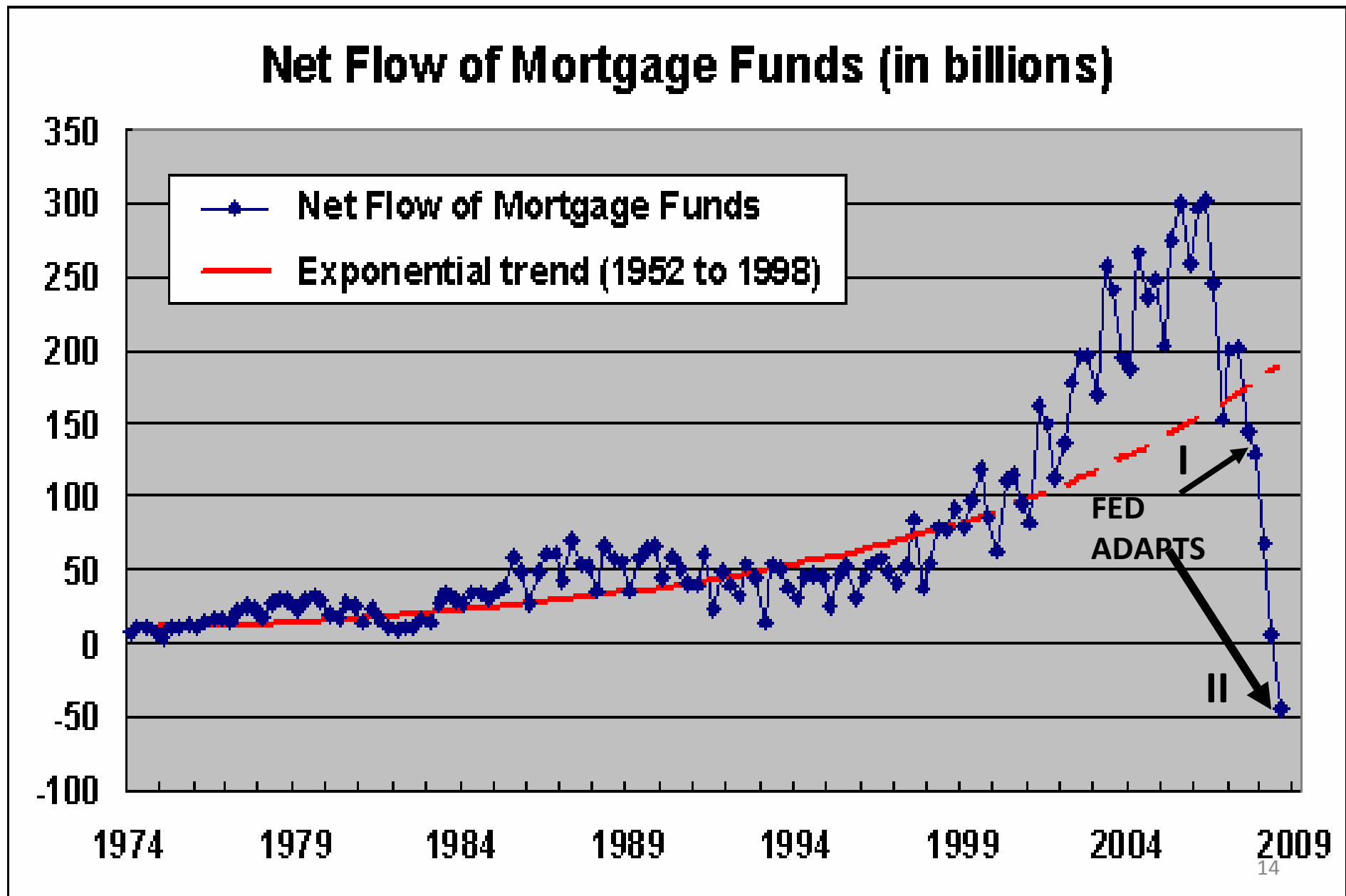
Republicans (For: 193; Against: 2).

Democrats (For 181; Against: 2).

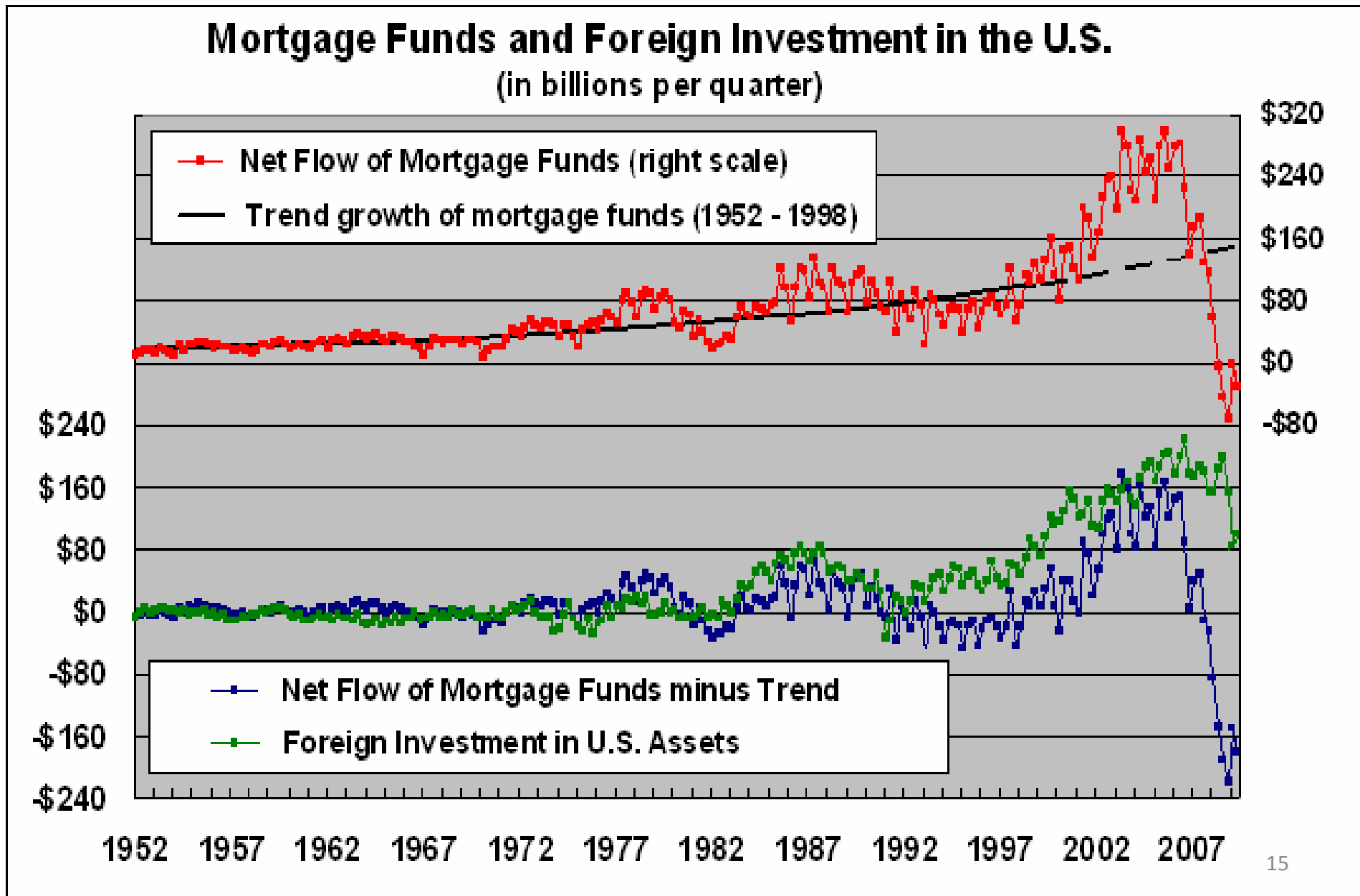
What Was Wrong with Derivatives?

- Nothing, except they were not exchange listed, like stocks, and therefore margined and collateralized! Problem was the same as with house mortgages that were inadequately collateralized by borrowers.**
- Derivatives market performed well as information markets, signaling to all, including Fed Res Chairman Bernanke, that a crisis was at hand**
- But they were not “insurance” which would have meant that those who guarantee against default would post reserve collateral.**

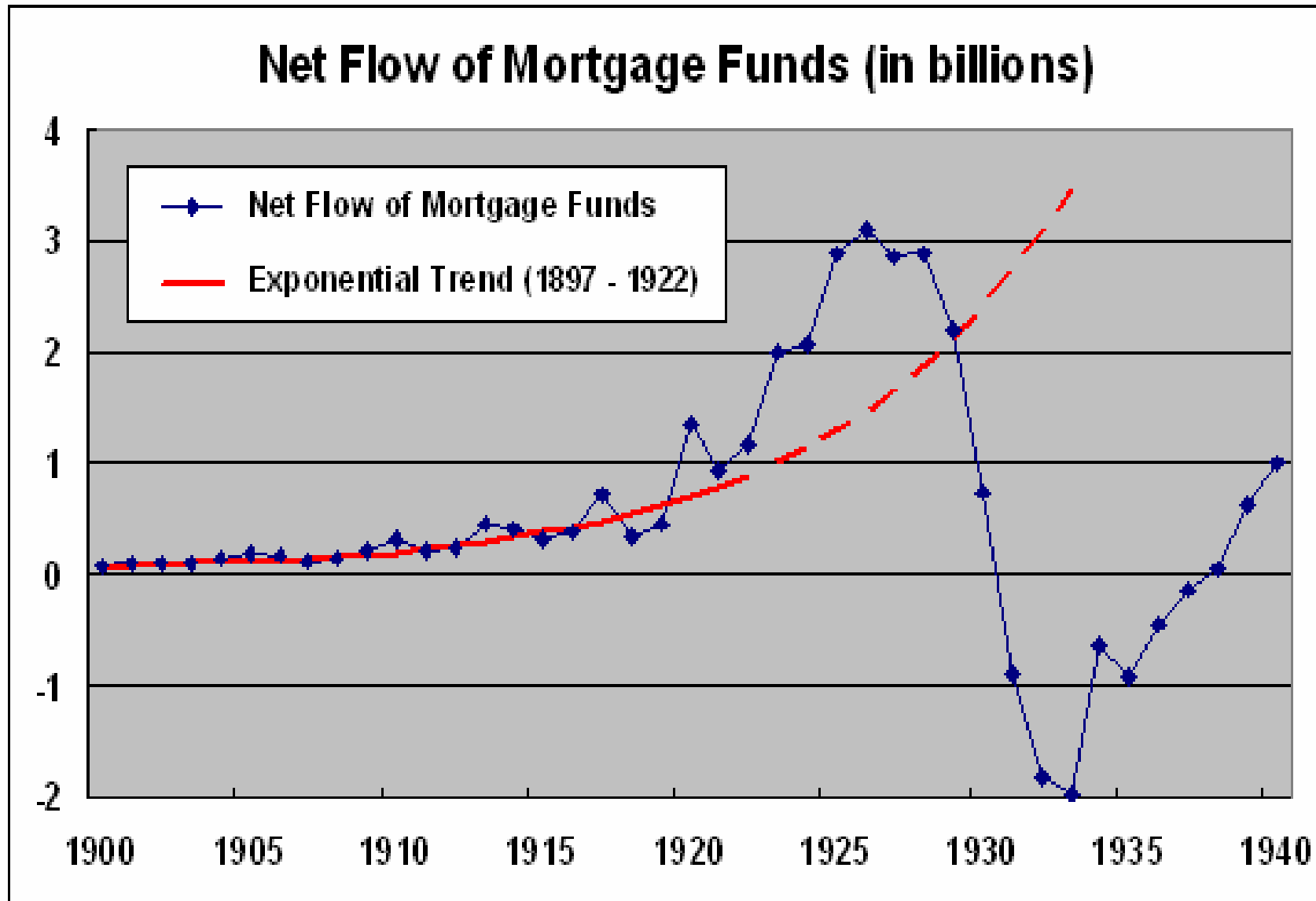
U.S. Housing-Mortgage/Finance Bubble Crashes



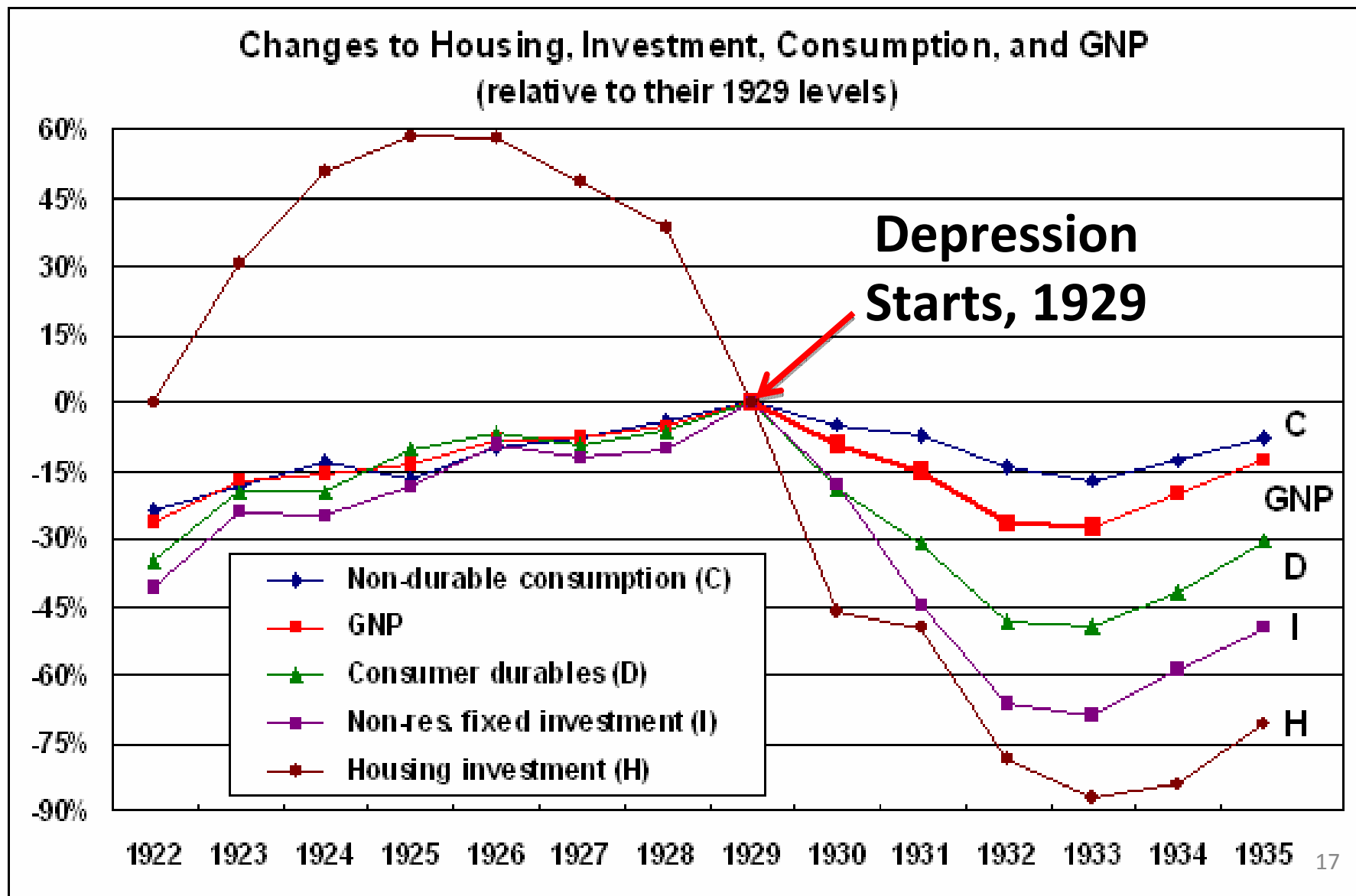
The housing bubble was also aided by a large inflow of foreign investment, a consequence of the US trade deficit.



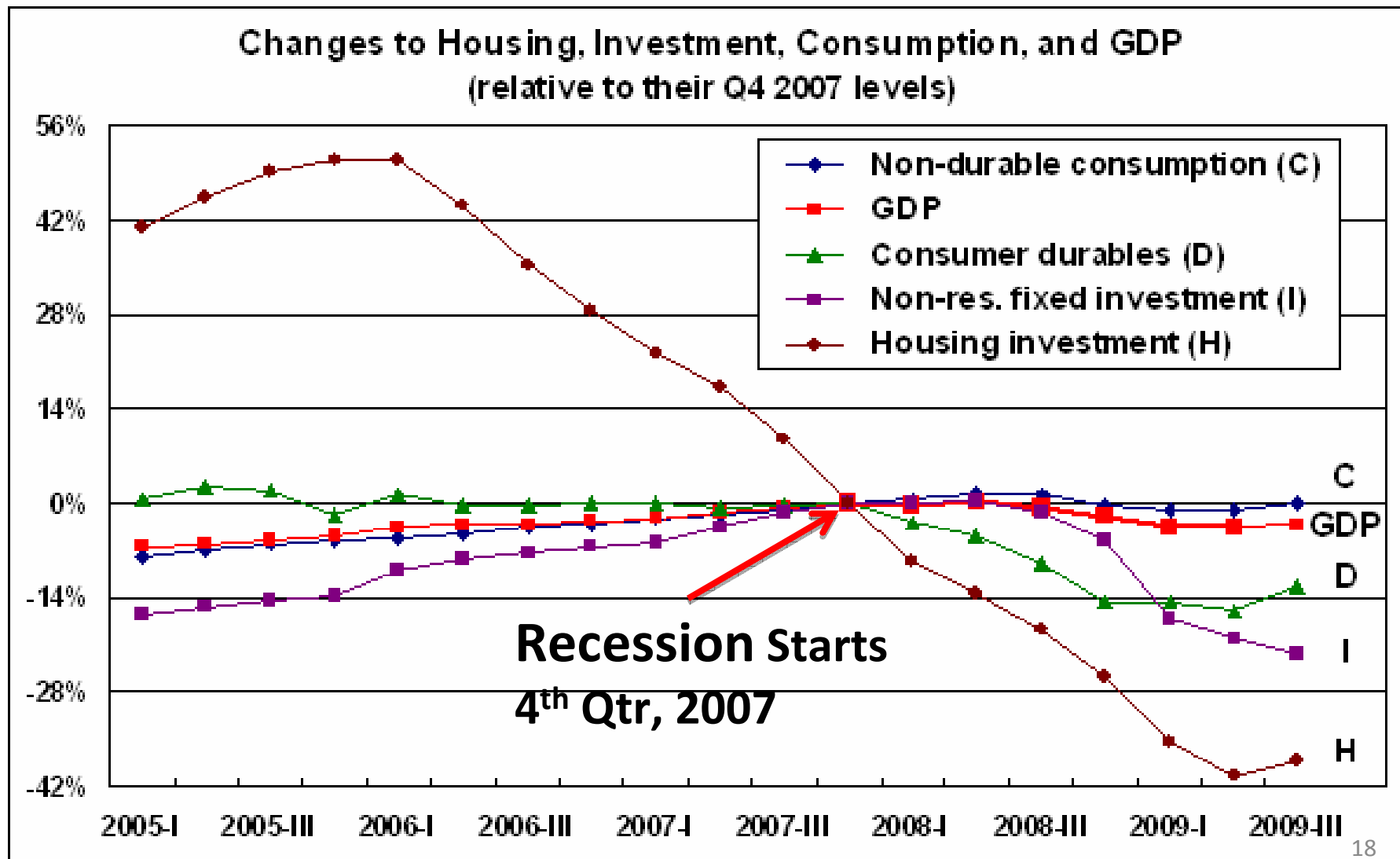
Parallels with the Great Depression: Mortgage Funds Declined *before* the 1929 Stock Market Crash, and 1931 banking crisis



1922-1933: Housing boom & expenditure collapse, 1927-28: impacts consumer spending, investment, and Economy.



Housing patterns are similar, if somewhat smaller in size and impact, 2005-2009. We await final outcome!



Some Conclusions

- 1. Experiments have long demonstrated that consumer goods and service markets are highly efficient & stable, while asset markets are prone to price bubbles and instability.**
- 2. This behavior is echoed in the US housing bubble, 1997-2006, and its collapse, 2006-9, with severe negative consequences for under-reserved home buyers, mortgage lenders, and derivative market “insurers.”**
- 3. This caused a freeze in credit markets and a broad decline in all private securities markets and in the economy in spite of Fed liquidity action and, over a year later, massive (\$1.2 trillion) purchases of financial assets.**
- 4. Expert leaders do not have practiced ‘knowledge how’ in handling infrequent severe declines; all are learning as**

- 5. The Great Depression evidences similar origins following the first housing, durable goods, credit consumption expansion in the 1920s.**
- 6. We appear to be in the second household-bank-firm balance sheet crisis; the first was the Great Depression.**
- 7. The problem was sparked by popular programs for stimulus of housing. The US public policy solution, paradoxically, has been more stimulus.**
- 8. The FR's Bernanke is in the process of testing the hypothesis that aggressive Federal Reserve Bank action can ward off a depression; economists generally believe that such action was far too timid in 1929.**