
Housing and the Financial Crisis in the US: Cause or Symptom?

Ashok Bardhan

After steady growth for a decade and a half, the US economy is now in the grip of a serious recession. While the source of the current economic crisis lies in the housing and housing finance sectors, the so-called subprime crisis should be seen as a symptom of deeper structural and politico-economic problems of today's globalized capitalism, rather than the primary cause of the broader crisis. Considering growing financial complexity and regulatory requirements, and issues of equity and fairness, Ashok Bardhan expects a greater role for government institutions in the future.

The Great Recession has the US economy in a vice-like grip. Not since the Depression has there been such a steady stream of negative economic and business news. The crisis started when a prolonged run-up in residential real estate finally came to an end in 2007. A downturn in housing prices led to rising foreclosures; the crisis spread to Fannie and Freddie, the government-sponsored enterprises, as well as to investment banks and other financial entities holding opaque, securitized assets backed by collapsing real estate. Credit markets became non-functional, rate spreads between risky and risk-free government debt skyrocketed, and the entire financial sector effectively became not just illiquid but insolvent. The woes spread to the real economy. At present, unemployment (9.8%) is higher than at any time since 1982, housing starts (beginning of construction on a housing unit) hover in the region of an annual rate of 500,000, the lowest in half a century, and auto sales at an annual rate of approximately 10-10.5 million are the lowest since 1981. It should be noted that the latter two figures do not even control for the sizeable increase in population in the intervening period.

What caused this sudden turn of events? How could an economy that seemed to be sailing along at a good clip in the 1990s, with a decent growth rate (average around 3% p.a.), low unemployment rates (reaching a nadir of 3.9% in 2000), steady productivity growth, and riding high on the innovative burst of the internet, have floundered so badly? True, there was the dot-com bust in 2000-2001, but that recession was short-lived, barely lasting for three quarters, and then it seemed that the economy was again back to its old

ways. But was it really? And was the old growth path sowing seeds of future troubles?

EVOLUTION OF THE CURRENT CRISIS

Why does the Genesis of the Current Crisis Lie in Developments related to the Housing Sector?

While real estate in general, and housing in particular, are of critical importance to any economy, their role in the US economic structure is particularly significant. This is due to several factors, chief among which are the size of the sector, its linkages to other sectors in the economy, and the social and political implications of an industry that is interwoven into the fabric of the family and the community. In the US, annual housing sales as a proportion of total housing stock are very high (routinely in the region of a turnover rate of 5%), partly due to geographic mobility, demographics, immigration and so forth, making for a very active market. In addition, the recent explosion in the maze of intricate ties between the housing and housing finance sectors, on the one hand, and the broader banking and shadow banking system, on the other, make the housing sector integral to the fortunes of the economic system at large. In 2006, over 14 million new mortgage loans were originated, and the total amount of home mortgages outstanding crossed \$10 trillion, having doubled in a little over five years. CDO (collateralized debt obligations: structured securities backed by mortgages and other assets) issuance went up from \$20 billion in 2004 to \$180 billion in late 2006. The notional amount of outstanding credit default swaps (a kind of insurance contract on mort-

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gage-backed securities and bonds) reached \$69 trillion. The proliferation of these connecting threads from housing sales to high and speculative finance has been at the heart of the present crisis and has compounded the fungibility of money and financial flows.

Recognizing the importance of the housing sector, policymakers have long promoted home ownership as a bedrock of the US social and economic system. Starting with the depression era, the housing finance system evolved into a host of agencies designed ultimately to keep the cost of home ownership low, stable, and secure. From a sociological point of view, home ownership is believed to promote community-based values, nurture respect for law and order, and provide a stake in the stability and prosperity of the

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Starting in late 1990s, there was an unprecedented rise in house prices and sales transactions. This period saw the emergence of a number of facilitating conditions for supporting a housing bubble. First, historically low interest rates created a conducive financial environment for borrowing, while lax lending standards set up an accommodating institutional setting for subprime mortgages and other loans, involving little or no documentation, little vetting of creditworthiness of borrowers, zero downpayment requirements, very low initial "teaser" rates, and other

features. Second, at the level of social psychology, crucial conditions for a bubble were met, namely, that the base of the pyramid, i.e., retail level buyers, were replenished in large numbers, flushed with enthusiasm affirmed by a recent history of housing price growth, leading to a critical mass of people turning over a tidy profit. Finally, the memory of the technology boom

and bust had faded with little consequence and with the rates held low, the appetite for investments had few alternative channels. As a result, the top ten metropolitan areas saw home values increase by over 100 per cent between 2001 and 2006.

In 2006, the last year of the housing boom, the share of subprime mortgages in total mortgage originations reached 20 per cent, compared to only 6 per cent in 2002. By the second half of 2006, prices had peaked in most US urban housing markets. By the end of 2006, prices started declining and sales weakened. The year 2007 witnessed significant increases in defaults and foreclosures. By summer 2008, the crisis had spread to the larger financial system with the emergence of a general credit and liquidity crunch, widening spreads of interest rates in the private markets above US government bond yields, collapsing transactions in derivatives, and a disappearing market for loans of all kinds. The rest of the story – the failure of Lehman Brothers, and the effective nationalization of Fannie and Freddie and a broad swath of the banking and financial sectors – is too well known to bear repetition. Ever since the crisis began, the policy establishment has lurched from one initiative to another, with monetary easing, fiscal stimulus, and financial bailout being the policy lynchpins. The economy has not improved much. At the same time, through all this maelstrom of activity, the plight of homeowners and the burgeoning problem of

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entire universe of subprime loans is not necessarily socially harmful. Leniency in the rationing of bank credit as well as institutional arrangements that lower mortgage costs, give some people who would otherwise find it difficult to get a mortgage, the opportunity to own a home. Neither is a bump up in home ownership rates necessarily an adverse economic or social event. Indeed, US housing policy shows that subsidies work; wealth inequality in the US would be even higher were it not for the significant level of home ownership. However, part of the recent uptick in ownership rates was also due to speculative and non-sustainable purchases. The social sanction for a lifestyle supported by investment earnings rather than old-fashioned wages has promoted an obsession with speculative investments. Thus, both real estate speculators as well as poorer or credit-constrained households became willing participants in subprime financing.

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foreclosures have yet to receive the same level of policy focus and intensity.

CAUSE OR SYMPTOM?

Subprimes, The Borrower's Perspective

While subprime loans have been the focus of attention and denunciation, we should be clear that the

Subprimes, the Lender's Perspective

The incentives for lenders lay in a transaction fee-based compensation structure, and the possibility of a prompt risk transfer. Over 80 per cent of these loans were pooled and securitized by private financial institutions, a higher proportion than the relatively more creditworthy mortgages securitized and backed by Fannie and Freddie. Indeed, the mortgages were not just securitized, but there were secondary and tertiary securitizations, when secu-

rities were re-pooled, repackaged, and again sliced and diced to generate yet another batch of securities/derivatives. This process of securitization, while doing an admirable job of generating liquidity for lumpy, non-liquid assets, did not just disperse risk but also succeeded in distancing mortgage originators from the ultimate investors in mortgage securities. The risk dispersion and diversification benefits of securitization were finally overshadowed by the informational opacity and uncertainties of the underlying mortgages. Ultimately, it led to risk doubly compounded—the most inexperienced and risky borrowers were sought out, offered mortgages on sometimes disingenuous and deceptively easy terms; these mortgages were precisely the ones that were securitized, leaving investors in far-off lands holding securities they knew little about, and whose funds now generated more mortgages and higher house prices.

Why were there Historically Low Rates?

The phenomenon of global imbalances, reflected in the savings in emerging economies being channeled to the US through the medium of international capital flows, led to excessive liquidity and low interest rates. These capital inflows into the US have been partly due to a global shortage of creditworthy debt instruments, in contrast to the abundance of US treasuries. The role of the US as the “guarantor” of last resort, as a financial entrepot and routing point, and of the dollar as the reserve currency par excellence, at least for now, all contribute to US-centric financial flows. The Greenspan subsidy to the investor class should also be taken into account. Mr. Greenspan, the former Fed Chairman, kept interest rates low for a

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considerable length of time, thus mis-pricing risk economy-wide, but enabling Wall Street to operate at low cost. One of the key prices in the economy – the price of money itself — was subsidized to the benefit of private equity funds (which rely heavily on borrowed money to fund acquisitions), hedge fund operators (who also take on enormous leverage), and sundry other investors. In effect, the financial system evolved from providing subsidies to the home-owning class to showering subsidies on the investor class. The “cheap money” environ-

ment fostered a frantic search for higher returns, leading to higher risk taking and high leverage (huge debts on the buying side) as well as corner-cutting and dubious practices (on the selling side).

Global Imbalances

Technological advances and institutional developments have given rise to a new global division of labour, leading to huge volumes of trade, cross-border investments, and capital flows. This new international specialization, with manufacturing, resource, and some services industries in the developing world, and the main markets in the Western world has resulted in massive global financial flows that have exploded over the last decade. Large US current account deficits have been financed by China, Japan, and oil

exporting countries. The US-China globalization axis may have been critical but by no means was it the only game in town. Reckless lending by Western banks to East European clients drove much of the importing frenzy in those countries. In effect, in addition to trade generated by underlying patterns of global specialization and competitiveness, it seemed as if it was finance that drove and propelled international trade. One can understand the virulence and speed with

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which the crisis has spread if we recognize that in addition to over-financialization domestically, there was perhaps over-globalization internationally. A large part of the new trade volumes generated was a result of diversion from potential consumption by domestic consumers to consumption half-way across the world. There is an ongoing debate in China, for example, whether the economic wisdom of having nearly a 40 per cent share of exports in GDP has served the developmental goals of the country well.

Super-Securitization

The influx of new investors, and an incentive structure that rewarded new deals meant that deal-making, debt dispersal through sequential transfers of investments, and derivatives of derivatives proliferated. The opacity of the downstream instruments hastened the velocity of turnover of these instruments, and the uncertainty of the investment was captured by the determination of investors to find ever more gullible, neophyte buyers. The bandwagon effect led to a swift and prolonged bubble in housing, as well as in other asset classes. The sustaining fuel for this towering house of cards was the steady and robust growth in house prices, and at the first sign of weakness in the housing market, the entire structure began to unravel. The explosion of derivatives on borrowed money resulted in chained, linked, and joined-at-the-hip holdings for an entire string of investors and counterparties, where the weakest link in the chain could bring the whole lot down.

In the case of massive failure and mismanagement, there was to be, as a final gift from the powers on high, a guaranteed taxpayer financed bailout for the important and the well-connected. As the continuing bailouts attest, the issue of moral hazard is here to stay; indeed, all that the policy establishment may have done is just postpone the reckoning to another day.

While an asset price bubble can impart a transient feel-good glow, it seems that the financial sector has now transitioned to fulfilling a system-wide need for sequential bubbles as a key avenue to generating windfall profits in the absence of any dramatic innovations or productive investments taking place in the economy.

Why was there Lax Regulation?

A number of domestic, political and economic factors, as well as global geo-political developments in the 1980s and 1990s led, in the US, to an ideological fixation on keeping the government at arms' length, even at the cost of prudential regulatory structures. As many observers have pointed out, one of the consequences of this environment was the effective capture of the political and regulatory establishment by the financial sector. The complex character of some of the financial instruments served to hide the fact that a subtle subversion of the financial system was under way. The fundamental objectives of finance – i.e., allocation of savings to investors, risk mitigation, and hedging/insurance activity—were being un-

dermined not just by routine speculation but by naked gambling. For example, trades in credit default swaps between parties with no insurable interest are tantamount to a zero-sum gamble; any separation of the economically relevant party – the one with an insurable interest – from the transaction deprives the act of larger economic purpose and value-creation, and results in just a simple wealth transfer from one party to another.

Debt Explosion and Moral Hazard

The effective subsidization of credit markets, and in some cases, riskless resort to public money meant debt usage by consumers, businesses, investors, and speculators exploded. Consumer debt payments as percentage of disposable income exceeded 12.5 per cent after 2000. Household credit market debt

doubled from \$7 to \$14 trillion between 2001 and 2007. In 2009, for the first time ever, average equity held by households in their own homes fell below 50 per cent. Credit default swap contracts outpaced equity derivatives by a margin of three to one, and private equity deal making, heavily dependent on borrowed money, went through the roof. While the cost side was subsidized, there was a mad stampede on the revenue side to find short-term and, in the prevailing gold rush atmosphere, not just high but windfall profit opportunities, all lubricated by lax regulatory oversight. And of course, in the case of massive failure and mismanagement, there was to be, as a final gift from the powers on high, a guaranteed taxpayer financed bailout for the important and the well-connected. As the continuing bailouts attest, the issue of moral hazard is here to stay; indeed, all that the policy establishment may have done is just postpone the reckoning to another day.

Why is there A Systemic Need for Bubbles?

The credit-fed boom in housing created illusory wealth to the tune of trillions of dollars. At the macro-level of the economy, there was no incentive on the part of authorities to prick the bubble as long as it was in an inflating mode, since it boosted consumption driven by borrowings against the created paper wealth. While an asset price bubble can impart a transient feel-good glow, it seems that the financial sector has now transitioned to fulfilling a system-wide need for sequential bubbles as a key avenue to generating windfall profits in the absence of any dramatic innovations or productive investments taking place in the economy. The excessive risk-taking and the proliferation of speculative instruments may reflect a mismatch between

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At a global level, the crisis reflects the transformative impact of the rapid growth of emerging economies (India and China in particular) on the one hand, and the role of the US dollar as the weak fulcrum in the global financial system, on the other.

fund availability and productive and profitable investments in the developed world. Perhaps, part of the rationale behind the collective desire for a bubble reflects the deeper structural problems facing the underlying real economy in the US. While no one argues that the US economy has run out of its innovative steam and dynamism, it has certainly underperformed in the past decade as far as job cre-

ation is concerned. In July 2009, the private sector in the US has essentially the same number of jobs (107.6 million) as a decade ago in 1999 (108 mill). The decline of manufacturing, and particularly the rise of offshoring in both manufacturing and services have put the onus of job creation, and all the economic impact that flows out of it, on innovation; and sometimes, innovation seems to take the form of financial alchemy rather than a technological breakthrough.

ROLE OF GOVERNMENT AND REGULATORY BODIES

One can confidently conclude that there will be greater role for state structures and government institutions in the future, not just due to the structural likelihood of recurrence of crises, but the dramatic increase in financial complexity and its regulatory requirements, the increasing range of conflicting inter-

ests, and issues of equity and fairness. Indeed, if anything, the present crisis has shown that those who loudly proclaim the need for free markets and are wary of government intervention are precisely the ones most vehement in their entreaties for government bailouts.

The subprime crisis must be seen as a symptom of deeper structural and politico-economic problems of present-day globalized capitalism, rather than the primary cause of the crisis. These problems in-

clude (1) the incentive-institutional structure of the financial system; (2) the contradictions of present-day globalization (finance centres and entrepôts in the West, production centres in the East, savings generation in the East, and debt accumulation in the West); and (3) the ideological environment and obsession with free markets combined with irrational prejudice

against a government role of any kind. At a global level, the crisis reflects the transformative impact of the rapid growth of emerging economies (India and China in particular) on the one hand, and the role of the US dollar as the weak fulcrum in the global financial system, on the other. 🏹

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Ashok Bardhan is Senior Research Associate at the Fisher Center for Real Estate & Urban Economics, University of California, Berkeley. He has an MS in Physics and Mathematics from Moscow, Russia, an M.Phil in International Relations from New Delhi, and a Ph.D. in Economics from UC Berkeley. He is co-author of the book, *Globalization and a High-Tech Economy: California, US and Beyond* (Springer, 2004). His research includes papers on the impact of offshoring on firm

organization and management; impact of offshoring on jobs and wages; political economy of the financial crisis; and impact of global financial integration on real estate. His current research projects include the linkages between the higher education sector and the labour market and policy implications of the global economic crisis.

e-mail: bardhan@haas.berkeley.edu

"Government's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidise it."

— Ronald Reagan