Economic, Mortgage and Housing Rescue Bill

Testimony to House Committee on Financial Services

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I would like to thank Chairman Frank, Ranking Member Bachus, and the members of the Committee for this opportunity to discuss issues affecting the US economy. It is important to note that I am speaking for myself, and not for my employer, First Trust Portfolios LP.

I will summarize my written testimony, but respectfully ask that it be included in the record in its entirety.

As we all know, the economy and financial markets have been buffeted by turbulence. Defaults and delinquencies on mortgages (especially sub-prime loans) have risen rapidly, home prices have fallen, unemployment has risen, credit spreads have widened, and major U.S. financial institutions have taken large write-downs or have even been forced to sell themselves to avoid bankruptcy. Many prominent economists fear a recession.

Some even worry about another Great Depression, and Herbert Hoover has been discussed frequently. Unfortunately, many recent comments wrongly accuse President Hoover of sitting by idly while the economy collapsed. Nothing could be further from the truth. President Hoover was extremely active in the early 1930s, pushing unprecedented peacetime legislation and regulation, intervening in grain and labor markets, and using his bully pulpit to influence business decisions.

This is also true today – many unprecedented policy actions have taken place. The federal funds rate has been cut by 57% (5.25% to 2.25%), the most rapid seven month reduction in almost sixty years. Hundreds of billions of dollars have been injected into the US financial system, using new and innovative Fed lending facilities. Non-depository institutions now have access to the discount window and the Fed actively financed the purchase of Bear Stearns by JPMorgan Chase. Ten-years ago, a Fed-orchestrated meeting to assist Long-Term Capital Management was considered controversial.

A $150 billion stimulus bill has been passed, and the first rebate checks are scheduled to go out within weeks. Rules regarding Fannie Mae and Freddie Mac have been altered to allow more balance sheet leverage, and Federal Home Loan Banks (themselves a Depression-Era entity) have been authorized to buy more mortgage loans.

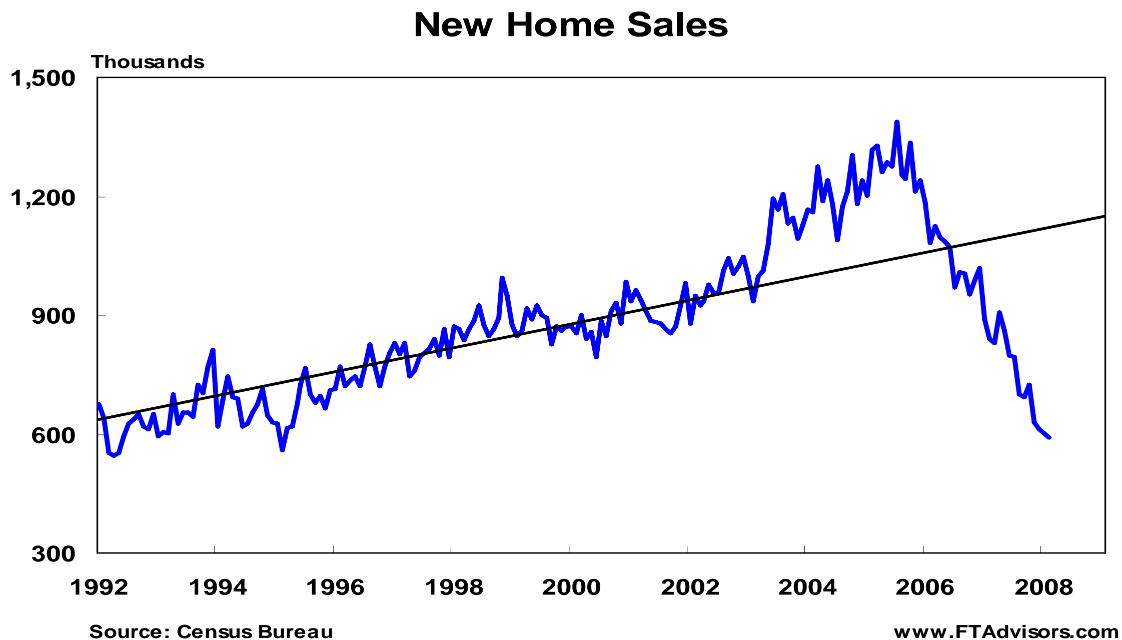
Now, Congress is proposing new legislation to help homeowners avoid foreclosure. Each of these actions, and every new proposal, is well intentioned. But, the road to serfdom is often paved with the best of intentions.

To discuss these issues today, I would like to ask and answer five important questions.

1) How did we get here?
2) Are today's problems unique?
3) Government Failure or Market Failure?
4) What Can the Government Do
5) Shouldn't we think twice before overreacting?

How Did We Get Here?

In hindsight, and as can be seen in the chart below, it is very clear that the housing market moved sharply above its long-term trend-line between 2003 and 2006. The question is: Why? Was it a shift in investor psychology? Was it just plain old greed?



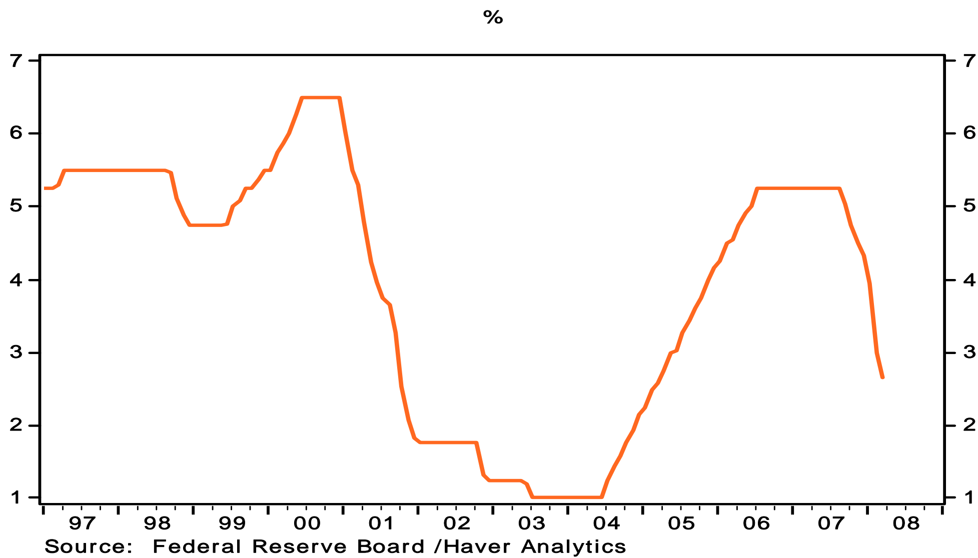
Some believe that the movement from fear to greed and back again is an almost random event. Or, as Herb Stein once said, "If something cannot go on forever, it will stop." Applying Stein's Law to housing says, "home prices will continue to rise and lending standards will continue to deteriorate until they don't anymore." At that point, whenever that is, the market faces a correction.

But this idea that consumers change from spendthrifts to misers overnight, or that investors shift from greed to fear randomly, is not supported by history. People don't change their nature; they change their behavior. They react. There are always "initiating causes" to any shift in consumer or business behavior. For example, people who live in Seattle own more umbrellas than people who live in Phoenix. This is not because people in Phoenix are spendthrifts, it's because it doesn't rain as much in the desert.

For the economy, the initiating causes of a change in behavior include the level of short-term interest rates, tax rates, regulations, and subsidies. All of these can influence incentives, and they therefore become driving forces behind a shift in economic activity.

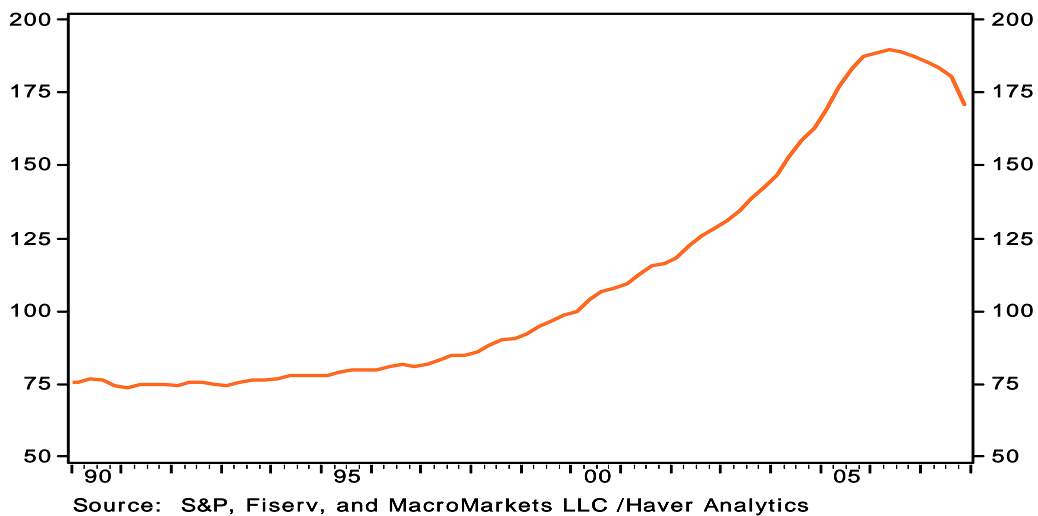
Ned Gramlich understood this. In a 2007 speech, the former Federal Reserve Board Governor outlined factors that led to rapid growth in subprime loans. One of those forces was the Community Reinvestment Act, which forced banks that operated in areas with low-income populations to make mortgages available to that community.

But the most important cause of the current mortgage market mess is excessively loose monetary policy between 2002 and 2005. The Federal Reserve cut the federal funds rate to 1.0%, held it there for too long, lifted rates too slowly and predictably, and eventually stopped short of truly tightening monetary policy.



Interest rates were so low for so long that many people started to think they would stay low forever. Many adjustable-rate mortgage (ARM) borrowers thought they could refinance in one, two, or three years at the same low introductory rate they first agreed to pay. They took a calculated risk. Even Alan Greenspan, in February 2004, argued that ARMs were perhaps a better choice than fixed rate mortgages.

The extra demand for housing, driven by low interest rates and lax lending standards sharply lifted the price of homes. The S&P/Case-Shiller National Home Price Index jumped by 60% between the fourth quarter of 2001 and the fourth quarter of 2005. Many regions of the country experienced much larger price appreciation than the national average and in these areas creative mortgage financing was used extensively.



The S&P/Case-Shiller index increased from roughly 80 in 1996 to 190 in 2007. Its recent decline to 171 has taken it back to early 2005 levels, but most homeowners have still experienced significant price appreciation.

Accommodative monetary policy was the grease in the wheels that allowed all this to take place with minor disruption to other sectors of the economy. Money was available to almost anyone, and it was cheap. Monetary policy was so loose and interest rates were so low, that housing became an investment that was too good to be true. Everyone wanted in, not realizing that much of these market movements were caused by an inflationary monetary policy.

Economists never know exactly what sector of the economy will be most affected by easy money, but in retrospect it is clear that in the 2000s, a great deal of the inflation ended up in the housing market, causing lenders and borrowers to drop their guard and take more risk than was prudent.

The Fed did not understand this at the time. If it had, it never would have left interest rates so low for so long. But in the early 2000s, gold, oil and other commodity prices rose sharply and the dollar fell abruptly. These market signals clearly indicated that Fed policy was too loose, but the Fed chose to ignore these signals at that time.

While some say that the Fed helped foment financial market problems with a lack of regulation, this is simply not true. There are few entities in the economy more regulated than commercial banks, yet the regulators were oblivious to the risk of excessive mortgage lending. The real problem was that regulators, banks and home buyers all believed that low interest rates and rising home prices were real, not a mirage.

When the Fed finally lifted rates back to "near normal" levels in 2006, the housing market lost its artificial support and fell sharply to levels well below the previous 15-year trend-line. In retrospect, this was inevitable.

Some argue that the US real estate boom could not have been caused by the Fed because real estate markets boomed in almost every major country around the world. But there are three flaws in this argument. First, the US is the only market that had such dramatic reductions in lending standards. Subprime loans are a unique American invention. Second, the demand for real estate in much of the developing world has been driven by the rapid spread of freedom and its commensurate increase in wealth (for example, in Ireland). The US benefited from this, but not as much as many foreign markets.

Third, other countries have not experienced financial problems anywhere near the magnitude of the US. Most of this is because the US has run the easiest monetary policy of any developed country since 2002, but it is also true because of mark-to-market accounting rules.

Mark-to-market accounting rules are a fine idea in normal times, but when markets are illiquid, these rules can create serious problems. Banks and other financial institutions are being forced to write-down security prices to levels well below true fundamental value, creating phantom losses and reducing capital. This forces banks to raise new capital, dilute current shareholders and reduce liquidity even further. When banks face capital problems they buy more Treasury bonds and make fewer loans. As a result, mark-to-market accounting rules are compounding economic problems.

Are These Problems Unique?

While it is safe to say there has never been a subprime mortgage crisis before, it is also safe to say that today's problems are not much different that those we have seen in the past. In fact, during the 1970s and 1980s, the oil and oil loan market went through the same set of problems that the housing market is going through today.

The Federal Reserve ran an extremely accommodative monetary policy in the 1970s. Inflation climbed from the low single digit level into double digits and oil prices surged from $3.56 to $39.50 per barrel (the equivalent of roughly $100/bbl. in 2008 dollars).

Many investors thought oil prices would never go down again, and predicted that "peak oil" was right around the corner. Lending expanded dramatically, with many banks feeling as if oil loans were not risky at all. They were wrong. When Paul Volcker tightened monetary policy and Ronald Reagan deregulated energy markets, oil prices fell by 25% to under $30 in late 1983, then to $25 per barrel in late 1984. Penn Square Bank in Oklahoma was a major oil lender and was the first to go under in 1982.

While not as sophisticated as the securitized mortgage market, Penn Square sold participations in its oil loans to other banks. Continental Bank in Chicago (the eighth largest bank in the US) was one of those banks, as was Seafirst Bank in Seattle. All three of these banks failed. Insured Penn Square depositors were made whole, but non-insured depositors were not. Seafirst was bought by BankAmerica Corp., but Continental Bank was considered "too big to fail" and all its depositors were reimbursed after a direct federal bailout of the institution.

The economy moved through this crisis with minimal problems. The 1980s witnessed the second longest recovery in history up to that point. Interest rates, inflation and unemployment fell, and the stock market soared.

And all of this excellent economic performance continued despite the fact that the Savings & Loan industry became a victim of the 1970s inflation as well. When short-term rates and inflation shot up in the early 1980s, S&L's had to pay much higher rates to depositors than they could afford. After all, they still held many very low single-digit fixed rate mortgages from the 1960s and early 1970s. In other words, monetary policy mistakes in the 1970s helped cause losses of roughly $250 billion in the S&L industry.

Today's subprime loan problems, along with the Great Depression, the 1970s oil crisis, and the S&L crisis, can be blamed to a large extent on monetary policy mistakes. Understanding this is the first step to fixing the problems ahead. And one important lesson of history is that trying to fix monetary mistakes with fiscal policy compounds problems to a large extent.

Government Failure or Market Failure?

As should be obvious at this point, I have been making a case that government failure is more prevalent than market failure and that government failure is behind most of our current financial market problems.

Interestingly, many commentators have raised the specter of Herbert Hoover, and have suggested that the Great Depression was caused by his inactivity and inattention while the US economy fell apart in the 1930s.

But nothing could be further from the truth. One of the leading causes of the stock market crash and the decline in agricultural prices in the late 1920s and early 1930s was a harshly deflationary monetary policy. Rather than encourage the Fed to print more money, the Hoover administration signed the Smoot-Hawley Tariff Act into law in order to help fight off foreign competition and counteract falling farm prices.

President Hoover also used his bully pulpit to persuade businesses to keep wages high, despite deflation. After the market crashed in October 1929 he convened White House conferences on November 18, 21, 22, 27, and December 5. These meetings were designed to coordinate public and private sector actions to counteract the economic contraction. Hoover asked businesses to invest and keep wages high. He also accelerated government construction projects and increased public works projects.

The Treasury Department provided $100 million to make low interest loans to farm cooperatives, and in 1930 the government started to directly purchase wheat. In retrospect, it is clear that all this activity made the Depression worse than it would have been otherwise.

Protectionism caused global trade to collapse and pushed exporters and importers into bankruptcy. The Hoover tax hikes of 1932 reduced incentives to invest. Crop price supports encouraged excess production, causing even deeper price declines. Artificially high wage rates led to a more rapid increase in unemployment. The deflation caused by excessively tight monetary policy compounded all these problems and thousands of banks failed in the process.

If the Federal Reserve had started printing money immediately in 1929 and 1930, and government had not intervened to such an extent, the Great Depression could have been very mild and short-lived.

It is the lessons of the Great Depression that have encouraged the Federal Reserve to cut interest rates so aggressively in recent months. The Fed’s fears of a Depression have encouraged it to do everything humanly possible to stop any potential systemic problems in the global financial system.

What Can the Government Do?

Because financial markets move at lightning speed, and the real estate market moves glacially, losses have mounted more quickly at the investor level than at the homeowner level. And since there can be very few homeowners without lenders, the government’s focus on stabilizing the banking system is appropriate.

The good news is that a combination of private (foreign and domestic) and public (Federal Reserve, Fannie Mae, Freddie Mac, and Federal Home Loan Bank) capital should be more than enough to absorb the losses in subprime mortgages.

Even if 50% of all subprime mortgages move into delinquency, and banks recover only 50% of the value of homes that are foreclosed on, the total losses should peak at somewhere near $300 billion. In a $14 trillion economy, with more than $100 trillion in assets, losses of this magnitude can be absorbed relatively easily.

While many analysts want to double or triple count these losses – adding the loss on the home, with the loss to the investor, with the loss to the bond insurer – this is not appropriate. Every loss beyond the actual loss on the property is a zero sum loss. There is a winner and a loser and the gains and losses net to zero. This is not true at the street level. The loss on a home is not offset by a gain.

Institutions and investment vehicles that do not have adequate capital face extreme problems and are being forced out of business. There are numerous examples of this. However, making these problems worse is "mark-to-market" accounting regulations which force many financial institutions to write down the value of assets to below fundamental value and reduce their capital by an equal amount. This puts them in jeopardy of violating financial accounting regulations and forces them to dilute current shareholders.

In turn, these pressures on the financial system reduce the availability of credit and drive up the cost of mortgages. Higher interest rates then drive down demand for housing and lengthen the market clearing process. The market must clear before anything can get back to normal. In other words, mark-to-market accounting rules are making it harder for the economy to recover.

While it is true that falling home prices have pushed many homeowners into a negative equity position and that these homeowners are the most likely to walk away from their mortgages, it is also true that many of them have risked very little capital. In the final year or so of the subprime lending frenzy, no-money down loans became common. In essence, the lending institution became a landlord. While it was called a mortgage, the purchaser had no skin in the game.

The idea was that home prices would continue to increase and homeowners would grow into an equity position. Unfortunately, this did not happen for many homeowners as housing prices peaked in 2006. These are the homeowners most at risk of defaulting on their mortgage. However, because many of these people never put any money down in the first place, it is hard to see the actual economic damage that would result from allowing a foreclosure to take place.

In fact, after a foreclosure takes place, and the price of the home is marked down, someone who has wanted to buy a house but was waiting for lower prices can now enter the market. If the government steps in and negotiates a lower mortgage balance for the person who is currently living in the house this process is short-circuited. It's picking winners and losers and it up-ends the market clearing process.

Trying to save institutions and individuals from financial pain caused by bad decisions is a noble cause. However, the unintended consequences that result from an overactive government are palpable. The best the government can do is to make certain that the economy remains resilient so that it can absorb the losses already in train and provide a positive backdrop for recovery.

Shouldn't We Be Thinking Twice and Acting Slowly?

Thinking through issues is important. For example, the Fed's sharp cuts in interest rates over the past seven months have probably prolonged the recovery process. While they may have seemed appropriate at the time, they have compounded problems.

For example, Fed rate cuts are the most likely cause of a spike in oil prices from $70 in August 2007 to a recent all-time high of $110 per barrel. The rising price of fuel helped push four airlines into bankruptcy in just the past few weeks. Rising fuel prices have also put more pressure on consumers and other businesses.

It is these inflationary pressures that will eventually cause interest rates to rise from current low levels. Higher interest rates and rising inflation will interfere with business and financial markets in the years to come.

While it is true that lower short-term interest rates are helping many homeowners who have adjustable rate mortgages, it is also true that as long as consumers and businesses expect the Fed to cut rates again they will hold off on investment decisions. Why make a decision today if the Fed will cut rates next week? This has definitely contributed to the slow economy of recent months. A more rapid set of rate cuts, with a statement that there would be no more to come, would have alleviated this problem.

Better still would have been for the Federal Reserve to follow the approach of the European Central Bank (ECB). The ECB has not cut interest rates at all, but immediately made available large sums of liquidity that allowed European financial institutions to ride through the storm so far, but without boosting inflationary pressures.

Because the Fed eased aggressively, while the ECB did not, the value of the dollar has plummeted. This has encouraged capital flight away from the dollar. A foreign holder of US mortgage bonds has higher losses than a domestic holder because the foreign holder has taken a currency loss as well.

In other words, government action has compounded problems faced by the US economy. And this is why Congress should not move to get the government involved more deeply in the housing market.

A widespread effort by the federal government to create more homeowners is one of the key causes of today's financial market problems. Risking billions of taxpayer dollars to stabilize a situation that was caused by monetary policy to begin with makes as much sense as the government's actions during the Great Depression.

With large Fed rate cuts already in place, hundreds of billions of dollars coming from the Fed and other government agencies, and rebate checks almost ready to mail, the economy is highly likely to avoid a recession. While many people will face pain from their decisions in the years ahead, the real fear is that government action turns a significant problem into a gigantic one. Let's avoid that road to serfdom.