

## America's Houses of Cards

By **Joseph E. Stiglitz**

There are times when being proven right brings no pleasure. For several years, I argued that America's economy was being supported by a housing bubble that had replaced the stock market bubble of the 1990's. But no bubble can expand forever. With middle-class incomes in the United States stagnating, Americans could not afford ever more expensive homes.

As one of my predecessors as Chairman of the US President's Council of Economic Advisers famously put it, "that which is not sustainable will not be sustained." Economists, as opposed to those who make their living gambling on stocks, make no claim to being able to predict when the day of reckoning will come, much less identifying the event that will bring down the house of cards. But the patterns are systematic, with consequences that unfold gradually, and painfully, over time.

There is a macro-story and a micro-story here. The macro-story is simple, but dramatic. Some, observing the crash of the sub-prime mortgage market, say, "Don't worry, it is only a problem in the real estate sector." But this overlooks the key role that the housing sector has played in the US economy recently, with direct investment in real estate and money taken out of houses through refinancing mortgages accounting for two-thirds to three-quarters of growth over the last six years.

Booming home prices gave Americans the confidence, and the financial wherewithal, to spend more than their income. America's household savings rate was at levels not seen since the Great Depression, either negative or zero.

With higher interest rates depressing housing prices, the game is over. As America moves to, say, a 4% savings rate (still small by normal standards), aggregate demand will weaken, and with it, the economy.

The micro-story is more dramatic. Record-low interest rates in 2001, 2002 and 2003 did not lead Americans to invest more – there was already excess capacity. Instead, easy money stimulated the economy by inducing households to refinance their mortgages, and to spend some of their capital.

It is one thing to borrow to make an investment, which strengthens balance sheets; it is another thing to borrow to finance a vacation or a consumption binge. But this is what Alan Greenspan encouraged Americans to do. When normal mortgages did not prime the

pump enough, he encouraged them to take out variable-rate mortgages – at a time when interest rates had nowhere to go but up.

Predatory lenders went further, offering negative amortization loans, so the amount owed went up year after year. Sometime in the future, payments would rise, but borrowers were told, again, not to worry: house prices would rise faster, making it easy to refinance with another negative amortization loan. The only way (in this view) not to win was to sit on the sidelines. All of this amounted to a human and economic disaster in the making. Now reality has hit: newspapers report cases of borrowers whose mortgage payments exceed their entire income.

Globalization implies that America's mortgage problem has worldwide repercussions. The first run on a bank occurred against the British mortgage lender Northern Rock. America managed to pass off bad mortgages worth hundreds of billions of dollars to investors (including banks) around the world. They buried the bad mortgages in complicated instruments, buried them so deep that no one knew exactly how badly they were impaired, and no one could calculate how to re-price them quickly. In the face of such uncertainty, markets froze.

Those in financial markets who believe in free markets have temporarily abandoned their faith. For the greater good of all (of course, it is never for their own selfish interests), they argued a bailout was necessary. While the US Treasury and the IMF warned East Asian countries facing financial crises ten years ago against the risks of bail-outs and told them not to raise their interest rates, the US ignored its own lectures about moral hazard effects, bought up billions in mortgages, and lowered interest rates.

But lower short-term interest rates have led to higher medium-term interest rates, which are more relevant for the mortgage market, perhaps because of increasing worries about inflationary pressures. It may make sense for central banks (or Fannie Mae, America's major government-sponsored mortgage company) to buy mortgage-backed securities in order to help provide market liquidity. But those from whom they buy them should provide a guarantee, so the public does not have to pay the price for their bad investment decisions. Equity owners in banks should not get a free ride.

Securitization, with all of its advantages in sharing risk, has three problems that were not adequately anticipated. While it meant that American banks were not hit as hard as they would otherwise, America's bad lending practices have had global effects.

Moreover, securitization contributed to bad lending: in the old days, banks that originated bad loans bore the consequences; in the new world of securitization, the originators could pass the loans onto others. (As economists would say, problems of asymmetric information have increased.)

In the old days, when borrowers found it impossible to make their payments, mortgages would be restructured; foreclosures were bad for both the borrower and the lender. Securitization made debt restructuring difficult, if not impossible.

It is the victims of predatory lenders who need government help. With mortgages amounting to 95% or more of the value of the house, debt restructuring will not be easy. What is required is to give individuals with excessive indebtedness an expedited way to a fresh start – for example, a special bankruptcy provision allowing them to recover, say, 75% of the equity they originally put into the house, with the lenders bearing the cost.

There are many lessons for America, and the rest of the world; but among them is the need for greater financial sector regulation, especially better protection against predatory lending, and more transparency.

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