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HOW TO SOLVE THE U.S. HOUSING PROBLEM AND AVOID A RECESSION: A REVIVED HOLC AND RTC

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Within the last few months, the so-called "subprime mortgage crisis" has developed from a small blip on the economic radar screen to a situation that has threatened financial markets and financial institutions worldwide. This financial instability induced the Federal Reserve to announce a historically large 75 basis point decline in the federal funds rate on January 22, 2008. Financial experts and economists are suddenly talking of a U.S. recession in 2008, and the only question is how deep the depressing effects will be. There is even the possibility of a global recession. This recessionary threat has led the White House and Congress to announce a fiscal stimulus package consisting primarily of a one-time tax rebate of between $300 to $1200 for families within defined income limits, plus a temporary tax reduction for business making certain investments in 2008. This stimulus plan is surely too little and too late.

Just a little over a month ago, many of the "best and the brightest" economic experts were not in favor of any fiscal stimulus package. *The Wall Street Journal* reported that former Federal Reserve Chair Alan Greenspan recommended that politicians do nothing to prevent a possible recession as a result of the subprime mortgage lending mess.[1] Greenspan preferred to let the market solve the problem by "letting housing prices (and security pegged to mortgages) fall until investors see them as bargains and start buying, stabilizing the economy." But if Congress does nothing, then a year from today we may be mired in the Greatest Recession since the Great Depression.

The proposed stimulus package will bring forth some additional household and business spending. Nevertheless, perhaps as much as 20 percent of each dollar of household tax rebate will go to buy cheap foreign imported goods, and therefore will not stimulate demand for American produced goods. Another 20 to 30 percent of household rebates may go into reducing household credit card or other debts, or directly into savings accounts. Accordingly, perhaps as little as fifty cents on the dollar will stimulate the economy. Not much stimulus bang for the buck!

The temporary tax cuts for businesses may not stimulate much additional investment as long as domestic market demand remains slack. Moreover, since the business tax relief is temporary, it encourages moving investments that may already be scheduled for next year into today's tax reduction period, thus creating a potential further decline in demand after the tax relief expires. In sum, any temporary fiscal stimulus package is likely to have temporary, and small if any, positive effects to offset the forthcoming recession in 2008.

As I will discuss below, the original subprime mess has ultimately resulted in an insolvency problem for millions of U.S. households. The government's fiscal "stimulus" plan does not directly address this insolvency problem. The Federal Reserve pumping in more liquidity will not end the housing insolvency problem. Instead, I suggest a tried and true comprehensive program to create a major federal facility to refinance mortgages at low rates and extended maturities, and to finance new investment in private sector housing. The goal of this new lending facility will be to: 1) end the insolvency housing problem; 2) avoid a serious recession, and; 3) prevent similar financial bubbles due to securitization of loan-backed financial assets from developing in the future.

BANK SOLVENCY CRISES

A sage once said "Those who cannot remember the past are condemned to repeat its errors." So let's look at what history can teach us about what "caused" this housing bubble and how we can relieve the distress. After U.S. Stock Market Crash of October 1929, one out of every five banks in the U.S. failed.

Several years after the Crash and the beginning of The Great Depression of the 1930s, a U.S. Senate committee held hearings on the possible causes of the Crash. These hearings indicated that in the early part of the 20th century individual investors were seriously hurt by banks whose self-interest lay in promoting sales of securities that benefited only the banks. The hearings concluded that a major cause of the Crash was that banks, in the 1920s, significantly increased their underwriting activities of securities. Consequently, in 1933, Congress passed the Glass-Steagall Act, which banned banks from underwriting securities. Financial institutions had to choose either to be a simple bank lender or an underwriter (investment banker or brokerage firm). The Act also gave the Federal Reserve more control over banking activities.

As a result, for several decades bank originated mortgage loans were not resalable. The originating bank lender knew that he or she would have to carry the mortgage loan debt security over its life. If the borrower defaulted, the lender would bear the costs of foreclosure. Thus, the originating bank lender thoroughly investigated the three C's of each borrower—Collateral, Credit History, and Character—before making a mortgage loan.

In the 1970s, deregulation of U.S. banking activities began when brokerage firms began offering money market, high interest, check writing accounts that competed with traditional banking business. In the 1980s the Federal Reserve reinterpreted the Glass-Steagall Act to allow banks to engage in securities underwriting activities to a small extent. In 1987 the Fed Board allowed banks to handle significant underwriting activities including those of mortgage-backed securities, despite objections of Fed Chairman Paul Volker. When Alan Greenspan became chair of the Fed in 1987, he favored further bank deregulation to help U.S. banks compete with foreign banks, where the latter are often universal banks which are permitted to act as investment banks, take equity stakes, and the like.

In 1996, the Federal Reserve permitted bank holding companies to own investment banking affiliates that could contribute up to 25 percent of total revenue of the holding company. In 1999, after 12 attempts in 25 years, Congress (with the support of President Clinton) repealed the Glass-Steagall Act. In a 1999 article in *The Wall Street Journal* (a few days before Congress repealed the Act), Republican Senator Phil Gramm is quoted as telling a Citigroup lobbyist to "get [Citigroup Co-Chairman] Sandy Weill on the phone right now. Tell him to call the White House and get [them] moving."[2] Soon after Gramm's warning, President Clinton supported the repeal of the Glass-Steagall. Shortly after Congress repealed the Act, Secretary of Treasury Robert Rubin accepted a top job at Citigroup.

HOUSING MARKET CRISES IN HISTORY

Once Glass-Steagall was repealed, there were no legal constraints between loan origination and underwriting activities. Accordingly, there is a great profit incentive for a mortgage originator to search out any potential home buyers (including sub prime ones) and provide them with a mortgage. The originator can then profitably sell these mortgages, usually within 30 days, to an underwriter, or act as an underwriter to sell to the public exotic mortgage-backed securities. The originator therefore has no fear of default if the borrower can at least make his first monthly mortgage payment.

The underwriter typically packages these mortgages into collateral debt obligations (CDOs), Structured Investment Vehicles (SIVs), or other esoteric financial vehicles. He then sells tranches in these vehicles to unwary pension funds, local and state revenue funds, individual investors, or other banks domestically or overseas (e.g., Northern Rock in the UK) who, led on by the high ratings of these complex financial securities by rating agencies, believe these are safe investment vehicles. Thus, since the turn of the century, this process of packaging and selling mortgage-backed securities has helped finance the housing bubble that pushed housing prices to historic highs by 2005.

In a December 14, 2007 article, *New York Times* op-ed writer Paul Krugman defined the resulting housing bubble as where the price of housing exceeded a "normal ratio" relative to rents or incomes.[3] Like Greenspan, Krugman does not suggest anything that politicians can do to relieve the distress caused by the deflating housing bubble. Krugman believes the market will solve the problem by deflating house prices. He estimates that housing prices will have to fall by 30 percent to restore a "normal ratio." This implies that home values in the U.S. will decline by some six trillion dollars.

The result will be that many borrowers "will find themselves with negative equity" as their outstanding mortgage exceeds this "normal" market price of the borrower's house—an insolvency problem. Krugman indicates that no one can provide a quick fix for this problem; he suggests that it will "take years" for the market to clean up the insolvency housing mess.

In many states mortgages are non-recourse loans (i.e., after default and foreclosure the borrower is not responsible for the difference between the outstanding mortgage balance and the lower sale price at foreclosure). If Krugman's 30 percent house value decline is accurate, as many as 10 million households will end up with negative equity and will have a strong incentive to default. Millions of homeowners will lose their homes in foreclosure proceedings and investors in mortgage-backed securities will incur large losses.

THE HOLC

But a study of history can give us clues as to how to solve the problem. The Roosevelt Administration's handling of the housing insolvency crisis of the 1930s suggests a precedent for dealing with the U.S. housing bubble distress. In 1933, the Home Owners Refinancing Act created the Home Owners' Loan Corporation (HOLC) to refinance homes to prevent foreclosures, and also to bail out mortgage holding banks. The HOLC was a tremendous success, making one million low-interest loans which often extended the pay-off period of the original loan, thereby significantly reducing the monthly payments to amounts that homeowners could afford. In its years of operation, the HOLC not only paid all its bills, but it also made a small profit.

Other measures might include setting up a government agency to take non-performing mortgage loans off the books of private balance sheets and therefore remove the threat of insolvency for those who took positions in the mortgage-backed securities after being misled by rating agencies. The result will prevent further sell-offs causing financial distress in all financial markets. The Resolution Trust Corporation, set up by the government, did remove non-performing mortgage loans from Building Societies' balance sheets after the 1980s Savings and Loan bank crisis, thereby preventing further financial damage to others. Also, Congress might consider a 21st Century version of the 1930s government-sponsored Reconstruction Finance Corporation to help finance investments and operations in the private sector housing and related industries during this insolvency crisis.

Congress should act promptly to create the necessary government agencies to help clean up this mess rather than wait out the "years" that Krugman suggests it would take if we leave the solution to the market. Moreover, the Greenspan-Krugman market solution will cause collateral damage to many innocent economic casualties (e.g., homeowners in neighborhoods where foreclosures are prevalent, and workers and business firms in construction and related industries).

While we wait for Congress to act on this proposed program, it may be desirable for the Federal government to start up an infrastructure rebuilding program to help stimulate the economy out of a potential forthcoming recession and increase productivity in the longer run. There is sufficient evidence that more than 50 percent of U.S. bridges and other public structures are in a weakened or failing condition. What better way to offset a possible recession in the construction industry and at the same time contribute to improvements in our nation's transportation productivity? Every dollar spent on rebuilding and improving infrastructure will create jobs for U.S. workers and profits for domestic enterprises.

RESPONSE TO POTENTIAL NAY-SAYERS

There will be those who say that this proposed solution to the housing bubble problem will be too costly. Moreover, they will question why U.S. taxpayers should bail out banks, other financial institutions, individual investors, and individual subprime borrowers who made foolish decisions. To help these institutions and individuals will merely introduce the "moral hazard" problem: protecting individuals and institutions from economic losses they would otherwise suffer due to their previous foolish decisions will only encourage them (and other fools) to make more risky decisions in the future since, if their actions result in large economic losses, they believe the government will step in to bail them out. What is the proper response to nay-sayers who raise these arguments?

First, the real cost of a serious recession in 2008 is very large if we do nothing but hope that the Federal Reserve continues to lower the interest rate that they charge banks. The above proposal assures that, at worst, a mild slow down will occur in 2008, and more likely the U.S. economy will experience substantial economic growth while rebuilding productive infrastructure. Clearly these benefits exceed the potential real costs of a recession that could last several years.

Second, this proposal avoids the significant collateral economic damage to many innocent bystanders that will occur if we rely on the market to reduce home prices by 30 percent. These innocent bystanders include: 1) existing homeowners, especially in areas where there are large number of neighborhood foreclosures; 2) potential home buyers who have deposits on unfinished homes where builders file for bankruptcy (*The New York Times* recently featured a front-page article about this regarding Levitt Builders in the Carolinas[4]); 3) unemployed workers and businesses in the building and home furnishing industries; 4) local governments that put their revenues into CDOs thinking that their money was in a safe investment, and; 5) some pensioners who might find their annual pension income declining as the pension fund takes a loss on its investment in mortgage-backed assets.

If this proposal is adopted, which banks will be bailed out? Probably very few banks, except the large ones who have combined normal banking affiliates with investment banking underwriting subsidiaries under the banking holding company cloak (e.g., Citigroup). There are news reports that upon occasion these big institutions provided some "liquidity puts"(i.e., promised to buy back some tranches of their asset-backed packages), which means that if financial stress occurs, these banks' off-balance sheet liabilities might have to be moved back to on-balance sheet of the bank and/or its underwriting affiliate. That partly explains the big write-offs of Morgan Stanley, Merrill Lynch, etc. But these big bank institutions are "too big to fail" anyway, so some bailout must be arranged. Small regional banks often are not big enough to engage in significant underwriting activities. If, however, they did create mortgage-backed assets that they sold to the public, then the liability of default has probably already been passed off without any "liquidity put" guarantees.

The last refuge of those who argue against bailout is the "moral hazard" argument. But if Congress passes a 21st Century equivalent of the Glass-Steagall Act, which prohibits making bank loans resalable, then we will have legally prevented those who have been bailed out from again originating risky loans that they can push off their balance sheets within a month or so.

History also tells us that the distress to U.S. taxpayers for extensive bail-out programs is not significant. Did most taxpayers notice any significant cost of resolving the S&L crisis, despite the media's constant argument that taxpayers would suffer? Did individual and corporate income tax rates increase as a direct result of the S&L problem?

THE FALLACY OF THE TAXPAYER COST QUESTION

The question of taxpayer costs for bailouts of financial institutions is typically part of discussions by the mass media. The question "what is it going to cost the U.S. taxpayer?" reflects an unthinking bias against active government policies to prevent recession and depression. Asking how much an active government policy to prevent a financial market calamity is going to cost the taxpayer can only be based on an economic theory that assumes that the macroeconomic activity in the economy will be unchanged whether or not the government takes any positive action to remove distress in financial markets. In other words, underlying this question is the micro theory ceteris paribus assumption—where the ceteris paribus is that the nation's GDP will, in the long run, follow an unchanging long-run permanent full employment trend line.

Accordingly, if there is a recession due to some financial distress, it is conceived as representing an X percent fall below this trend line for a period of time before some automatic market mechanism restores the economy to the predetermined full employment trend line. If, on the other hand, the government takes some positive policy action to resolve the housing insolvency finance problem, then, it is presumed, there must be a Y percent taxpayer cost deduction from the trend line. When the problem is framed in this rhetoric, then it appears obvious that one should compare the magnitudes of X percent vis-à-vis Y percent reduction from the trend line. If Y percent is greater than X percent, then no government action should be taken.

Since the cost of a forthcoming recession cannot be accurately predicted except after the fact, while one can always make some estimate of the cost of operating a government program, it should be obvious that the government plan can always be painted as larger than the cost of a mild recession. Consequently, the rhetoric of this cost to taxpayer question will almost always favor the "do nothing" argument, because it assumes that the economy has some automatic market mechanism that assures that the GDP will always quickly return to a full employment level of GDP.

In the real world, however, there is no predetermined, long-run GDP full employment trend line. The macroeconomic performance of the U.S. economy will be substantially improved in both the short- and long-run if the government takes direct action. If, on the other hand, the government leaves it to the market to solve the problem, the result will be an economic recession that might even collapse into a depression. Consequently, the income of American taxpayers will, on average, be significantly improved if government takes action than if we rely on the market to solve such problems. If the government does nothing, U.S. residents stand to experience a severe reduction to their income levels. Accordingly, a properly designed policy to avoid financial and economic depression provides only benefits—not costs—to the nation's economy.

Let us look at a historical example where if this type of "what will cost to the tax payer and/or the economy?" question were asked, one of the most desirable government policies would never have been undertaken. At the Bretton Woods conference it was recognized that the European nations would need significant aid to help rebuild their economies after the war. Keynes estimated that the need would be between $12 and $15 billion. U.S. representative Harry Dexter White indicated that Congress could not ask the taxpayers to provide more than $3 billion. Accordingly, the Keynes Plan was defeated at Bretton Woods, and the Dexter White proposals were adopted

Suppose that in 1946 it was recommended that U.S. give a gift of $13 billion dollars over four years to various European countries to help them rebuild their war-ravaged economies (in 1940s current dollars, this sum would be well over $150 billion in 2007 dollars). Obviously if Dexter White was correct, the Congress would never have approved the Marshall Plan. Since the Marshall Plan did not reveal in advance that it would provide foreign governments $13 billion over a period of four years, Congress approved the Marshall Pan. The Marshall Plan gave foreign nations approximately two percent of the United States' GDP each year for four years. Was the Marshall Plan costly to U.S. taxpayers and the U.S. economy?

The statistics indicate that, during the Marshall Plan years, for the first time in history the U.S. did not experience a serious economic slowdown immediately after a war. And this despite the fact that federal government expenditures on goods and services declined by approximately 57 percent between 1945 and 1946. Furthermore, four years after World War II, federal government expenditure was still approximately half of what it had been in 1945.

When the U.S. emerged from World War II, the federal debt was more than 100 percent of the GDP. Accordingly, there was great political pressure to reign in federal government spending to make sure that the federal debt did not grow substantially. Clearly, then, it was not "Keynesian" deficit spending that kept the U.S. out of recession in the immediate post-World War II years.

What was the cost of the Marshall Plan to the U.S. economy and the U.S. taxpayer? In 1946, the GDP per capita was 25 percent higher than it had been in the last peace years before the War. GDP per capita continued to grow during the Marshall Plan years. Despite giving away two percent of U.S. GDP, American residents (and taxpayers) experienced a higher standard of living each year.

Clearly The Marshall Plan did not make American taxpayers feel they were bearing a great cost in terms of real income.

The Marshall Plan was good for the European nations since the Europeans used the funds to buy U.S. exports needed to feed its population and rebuild it war damaged capital stock. In the United States, unemployment was not a problem despite nine million men and women being released from the Armed Services into the civilian population and labor force. The Marshall Plan financed a significant growth in U.S. exports that help offset, in part, the fall in aggregate demand due to a reduction in government spending. U.S. export growth was not the only offset as pent up consumer demand also expanded in the post-war period. Without the Marshall Plan, however, the U.S. export industries would not have expanded, and probably would have declined, as European nations exhausted whatever foreign reserves they possessed.

In sum, were there any real costs of the Marshall Plan as compared to doing nothing? A response that Americans were forced to reduce their living standards by approximately two percent would only be correct if one assumed that the GDP would have been the same in those early post-war years without the Marshall Plan. Can anyone really believe this?

THE ACCOUNTING COSTS OF INSTITUTIONS SUCH AS HOLC AND RTC

It has already been indicated that the HOLC actually earned a small profit over its life. From 1933 to 1935, the HOLC provided almost $3 billion in bonds to banks in exchange for mortgages, thereby reducing the pressure of potential economic failure for many banks. Moreover, if it were not for the HOLC more houses would have been foreclosed. The economic misery of the depression would have been worse. More Americans would have been living in the street (or Hoovervilles), while the U.S. housing stock would have depreciated much more rapidly due to the neglect of vacant foreclosed homes.

The HOLC financed all of its operations through either earnings or borrowing. Congress never appropriated any funds for the HOLC. [Notice this made the operations of HOLC an off-balance sheet operation.] The original act called for the HOLC to issue its own bonds with the interest guaranteed by the U.S. Treasury and with a maturity not to exceed 18 years. A year later the guarantee by the Treasury was extended to the principal as well. Although HOLC initially issued its bonds to the public, eventually the HOLC received its funds by borrowing directly from the Treasury rather than from the money markets. From 1936 to 1940, HOLC borrowed $875 million directly from the U.S. Treasury.

The RTC was a corporation formed by Congress in 1989 to replace the Federal Savings and Loan Insurance Corporation and to respond to the insolvency of about 750 savings and loan associations. As receiver, it sold assets of failed S&Ls and paid insured depositors. In 1995 its duties, including insurance of deposit in thrift institutions, were transferred to the Savings Association Insurance Fund.

The S&L crisis in 1989 occurred under a Republican Administration that had pledged "no new taxes." Nevertheless, the Administration recognized the difficulty of the problem involving the large number of S&L insolvencies, and it supported the formation of the RTC. The first Bush administration recognized, apparently, that the RTC would not require new taxes to burden the U.S. taxpayer with the cost of the program.

After much wrangling by Congress, the initial funding of the RTC included $18.8 billion from the Treasury and $31.2 billion from bonds issued by the RTC (and therefore an-off budget liability). In 1995, the RTC was folded into another larger government agency, and there has been no public accounting records provided to show whether the RTC operations ultimately made a profit or not.

In sum, although there are some accounting costs of setting up any institution similar to the HOLC and the RTC, these bookkeeping entries are unlikely to hurt U.S. taxpayers. The benefits from having such institutions alleviating economic distress far outweigh the costs of allowing deflationary market forces solve the problem of our bursting housing and financial bubble.

NOTES

1. Wessel, David. (2007). "Don't Count On A Stimulus Plan." *The Wall Street Journal,* December 20, 2007.

2. Schroeder, Michael. (1999). "Glass-Steagall Accord Reached After Last Minute Deal Making." *The Wall Street Journal,* October 25, 1999.

3. Krugman, Paul. (2007). "After The Money's Gone." *The New York Times,* December 14, 2007.

4. Streitfeld, David. (2008). "With Builder in Bankruptcy, Buyers Are Left Out." *The New York Times*, January 3, 2008.