

## **A Primer on the Current Economic and Financial Crises**

### **February 17, 2009**

#### **Some background:**

1. The world money markets were looking for places to invest over \$72 trillion in savings. Much of this saving came from emerging economies such as China and India. A common home for these funds was U.S. Treasuries since they are very safe. But rates on U.S. Treasuries were so low that money managers looked elsewhere. Buying mortgage loans seemed like a good way to make a good return safely.
2. With the decline in regulation, lenders were able to lend to people with no income, no job, and no assets (NINJA). (In Ohio, 21 loans were made to dead people.) Mortgage lenders were eager to make these loans because they would not hold the loans for long. Lenders would put a bunch of mortgage loans together, “bundle” them and sell them as Mortgage Backed Securities. The link between the holder of the loan and the borrower was broken.
3. To attract new borrowers, lenders developed “sub prime” mortgage loans. These were loans that had lower than market interest rates or loans where the payments did not reduce the principal but were “interest only” loans. With some loans, the payments were low, but there was a balloon payment at the end.
4. Home prices increased consistently, more than doubling between 1997 and 2006. It is estimated that over 1/3 of home purchases during this period were speculative; buyers were buying on the assumption that prices would continue to rise. They intended to buy a home, keep it for a short period, then “flip” the loan by selling the home at greatly increased prices.

#### **The Housing Market**

1. Easy credit increased the demand for housing.
2. Housing prices increased.
3. Non traditional loans further increased housing demand.
4. Supply increases eventually overcame demand increases and housing prices began to decline.
5. Speculators demand decreased and the bubble burst.
6. The “easy payment” periods of sub prime loans ended and interest rates and payments increased,
7. Overbuilding eventually caused housing prices to decline. The decline accelerated. As interest rates on the sub prime loans and house payments increased dramatically, and home equity began to fall, borrowers could no longer make their house payments. Many owed more on their homes than they were worth so they simply walked away from their homes. Housing prices continue to decline, fewer homes are being built, mortgage loans are difficult to get

#### **The Mortgage Market**

1. As long as borrowers' incomes were rising or housing values were rising, the sub primes loans worked well. The assumption of borrowers was the housing boom would continue

and they would be able to either continue making their payments, or sell their homes at a handsome profit. Many borrowers simply did not read the fine print and were unaware of the nature of their loans.

2. The mortgage markets developed many new “investment instruments” that took these very risky mortgage loans and “bundled” them (put them all together) into new investment instruments. Assume that I lend five people money to buy homes. I’m not sure that they will repay me so I “bundle” these five notes and sell them as a single IOU. I now have my money back plus some and no risk. These are called Mortgage Backed Securities (MBS). The MBS itself was not the problem; it was the fact that mortgage originators had tremendous incentives to churn out as many mortgages as they could, regardless of the quality, because they were paid a fee for each new mortgage they originated. Why would anyone buy them? Remember, there is a tremendous amount of saving looking for an investment opportunity. Treasury notes have a very low rate of return, so these MBSs look pretty good. Some people buy up a bunch of MBSs and bundle them into Collateralized Debt Obligations (CDO). These CDOs were thought to be “as good as money.” As long as housing prices continued to rise, these were fine but risky investments.
3. The chickens did come home to roost however, as borrowers saw their interest rates and payments increase dramatically after the initial “low interest rate” periods. As greater numbers of borrowers defaulted and foreclosures increased, housing prices began to fall. Many borrowers owed more on their homes than their homes were worth. Even more abandoned their homes and home values plummeted.
4. As people defaulted on their mortgage loans, the value of these “bundled packages” fell, putting those banks that had purchased them in danger.
5. As the value of MBSs and CDOs fell, investors lost their money. Credit dried up, businesses can’t get loans, banks aren’t lending to other banks, and a “credit freeze” has occurred.

### **The Real (Main Street) Market**

1. When housing prices were rising, owners took out “home equity” loans and “lines of credit,” increasing their willingness and ability to buy goods and services. With the burst of the bubble, this spending has fallen.
2. With slow demand for new housing, construction expenditures have fallen along with spending for large ticket durable goods such as appliances and furniture that people buy when they buy homes.
3. Construction businesses are laying people off and these newly unemployed households are not spending much.
4. People who can keep their homes have lost equity as home prices fall. They can borrow less than they could before and they are spending less.
5. The “wealth effect” kicked in; people who had no intention of selling their homes began to feel less wealthy. Consumer confidence fell and buying in the economy in general fell.
6. The lack of credit has also decreased demand for automobiles, causing people in automobile related sectors to lose jobs.
7. As credit “dried up,” businesses large and small were unable to finance inventories and other outlays usually used for business expenses. As a result, they laid off workers.
8. As people bought less, fewer people were hired. Job losses increased, decreasing the purchasing power of the economy.

9. The “multiplier effect” is causing less spending which is causing more job losses, which is causing less spending, etc.
10. Bottom line: many more people have lost jobs, many are having difficulty paying debts, and consumer confidence is very low. All of this contributes to a slowing economy and recession. There is no reason that we will get out of it anytime soon.

### **Financial Markets (Wall Street)**

1. Remember that the value of stocks is influenced largely by expectations of the health of the economy and future profits.
2. With the bad news coming from the housing sector and the financial sector, Wall Street has little confidence.
3. With little hope that equities will increase in value soon, some are tempted to sell all stocks and move into any other assets...bonds, commodities, etc., accelerating the price decline; corporate bonds are now offering very attractive yields that are comparable to long term stock returns. An investor can move up the capital structure (meaning they get paid first in bankruptcy) and earn a comparable yield to stocks.

### **The Obama bailout vs. the Republicans: Increase G or decrease T**

1. Obama’s plan emphasizes increasing spending (G)
2. The Republicans want decreased taxes (T)
3. Fiscal policy – changes in G have a greater impact on employment than changes in T since we don’t know what households will do with the tax break. Implementation lag
4. Why might 3 not always be true?

### **Ways to incorporate the crisis into your course.**

1. The housing market.
  - a. Prices rose because demand increases were greater than supply increases.
  - b. When people were unable to make mortgage payments, demand decreased. It fell further as expectations fell and wealth decreased. Speculative demand decreased causing greater demand decreases. Prices fall, houses are relatively less scarce, and quantity exchanged falls.
  - c. Fed increases in the money supply drove U.S. Treasury rates down so investors looked elsewhere....mortgage loans.
  - d. Speculators – speculative demand is just like any other demand. Increases in demand increase prices; decreases in demand decrease prices.
  - e. Sub prime mortgage market – people respond to incentives in predictable ways; every choice has a cost.
  - f. Main Street
    1. When housing prices were rising, people’s wealth increased increasing Aggregate Demand. As housing prices plummet, people’s wealth decreased, decreasing Aggregate Demand and employment.
    2. Purchase of durable goods fell, causing a decrease in investment.
    3. The expenditure multiplier worsens the situation.
    4. Construction falls, causing additional decreases in employment and income.
    5. Consumer confidence falls, causing a decrease in Aggregate Demand. See b. above.
    6. The credit crunch causes a further decrease in investment.

7. As a result of lower incomes, state and local governments have less tax revenue, causing a decrease in spending and employment.
8.  $AD = C + I + G + (X-M)$  All three components of domestic spending are falling and the multiplier is worsening the effect.
9. Fiscal policy – the idea is to increase G and lower T to “prime the pump.” Pure Keynesianism! Republicans and Democrats differ philosophically about government spending and taxes but the differing strengths of the impacts of changes in G and T on the economy are worth discussing. Implementation lags and the different employment effects of different types of spending are also worthy of discussion.
10. Monetary Policy – rates are so low that there is really nowhere to go. Monetary policy won’t get us out of this one.

**Some questions:**

Use Marginal Benefit/Marginal Opportunity Cost analysis to explain why some borrowers would walk away from their homes?

How do the following events affect the supply or demand for housing?

1. Easy credit
2. Government policies to encourage lenders to lend to low income borrowers.
3. Inability of construction to keep up with demand.
4. Speculation that housing prices would continue to increase
5. Builders overbuild
6. Credit tightens
7. Borrowers default
8. Speculators and others lose confidence

How do the following events affect C, I, G, and/or (X-M)?

1. Lower housing values, negative wealth effect.
2. Purchase of durable goods fell.
3. Expenditure multiplier as a result of (1) and (2)
4. Construction declines.
5. Consumer confidence falls.
6. Credit crunch
7. Loss in state and local government revenue
8. Increased federal government spending
9. Decreased federal taxes/increased state taxes