Housing Rarely Presages A Balance Sheet Crisis But Routinely Leads To Ordinary Recessions. Why We Are Stuck, And What's To Be Done.

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Directors Roundtable

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Chapman University

Based primarily on

RETHNINKING HOUSING BUBBLES,

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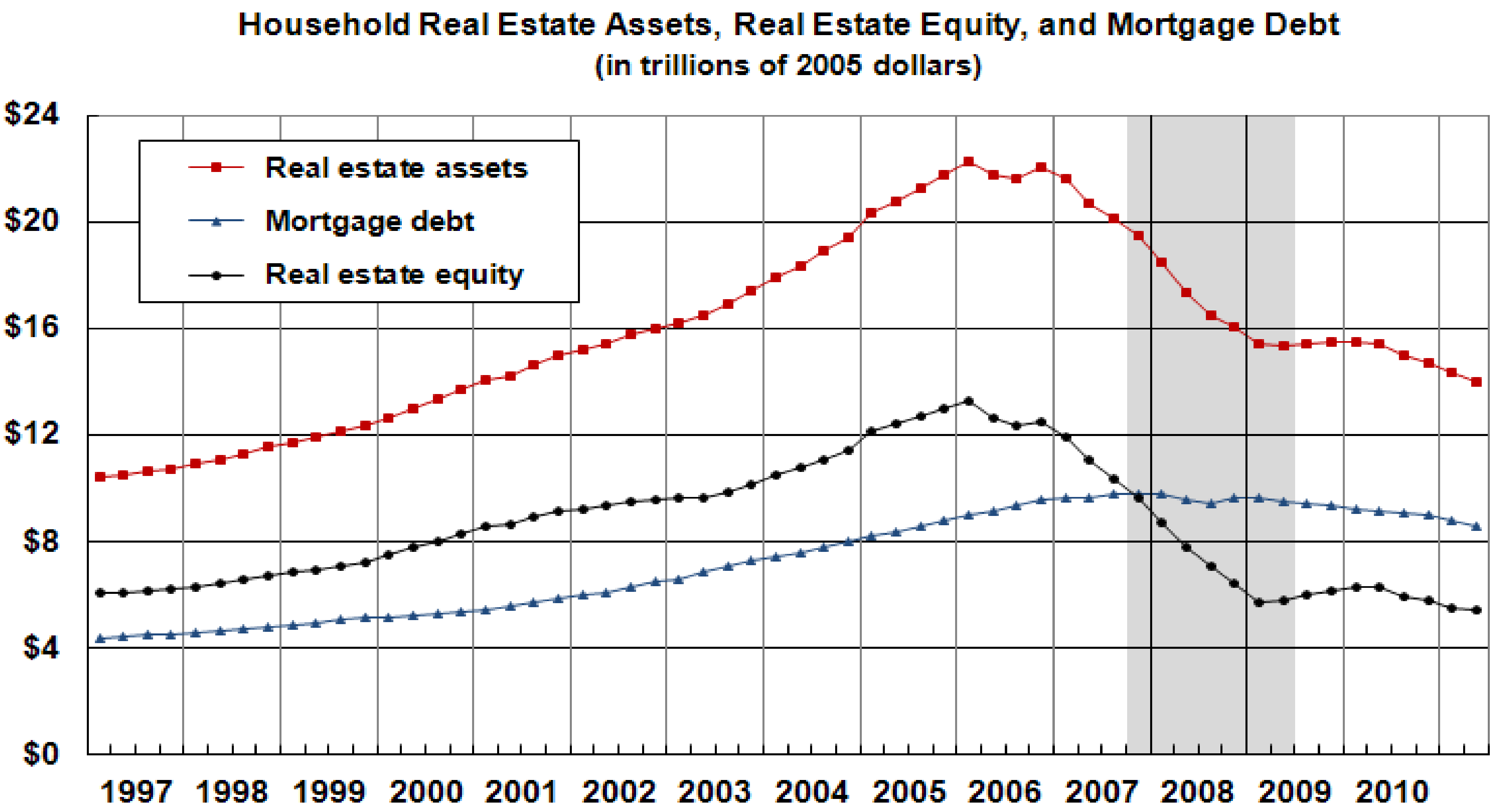
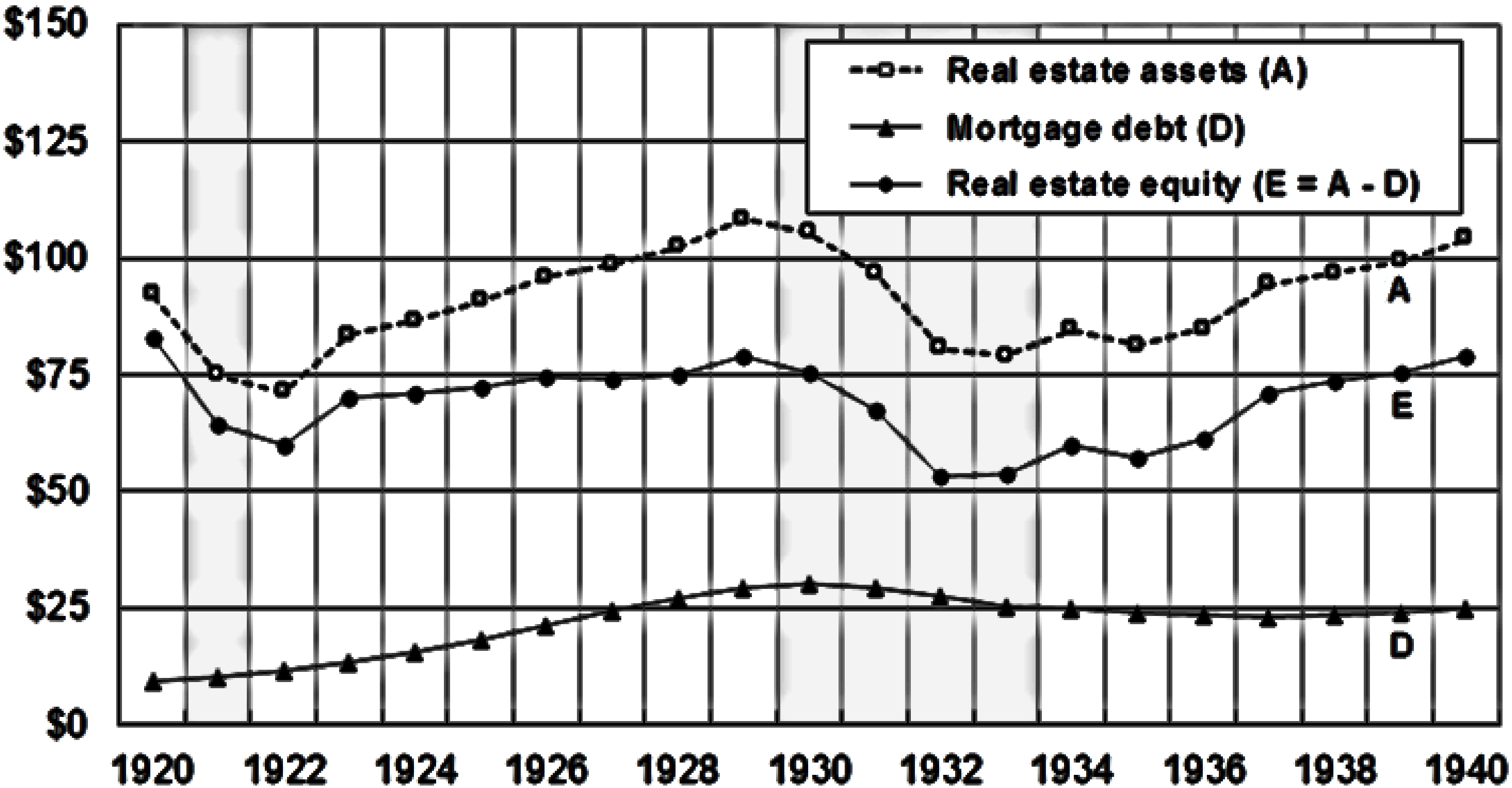
Proposition 1:
The Great Recession and Depression Viewed as Household-Bank Balance Sheet Recession Crises

Great Recession: As housing values rise mortgage debt rises in step, bubble-like, 1997-2006. With a drop in housing value mortgage debt remains fixed, declining only after a lag; equity (value minus debt) collapsed 2006-2009.

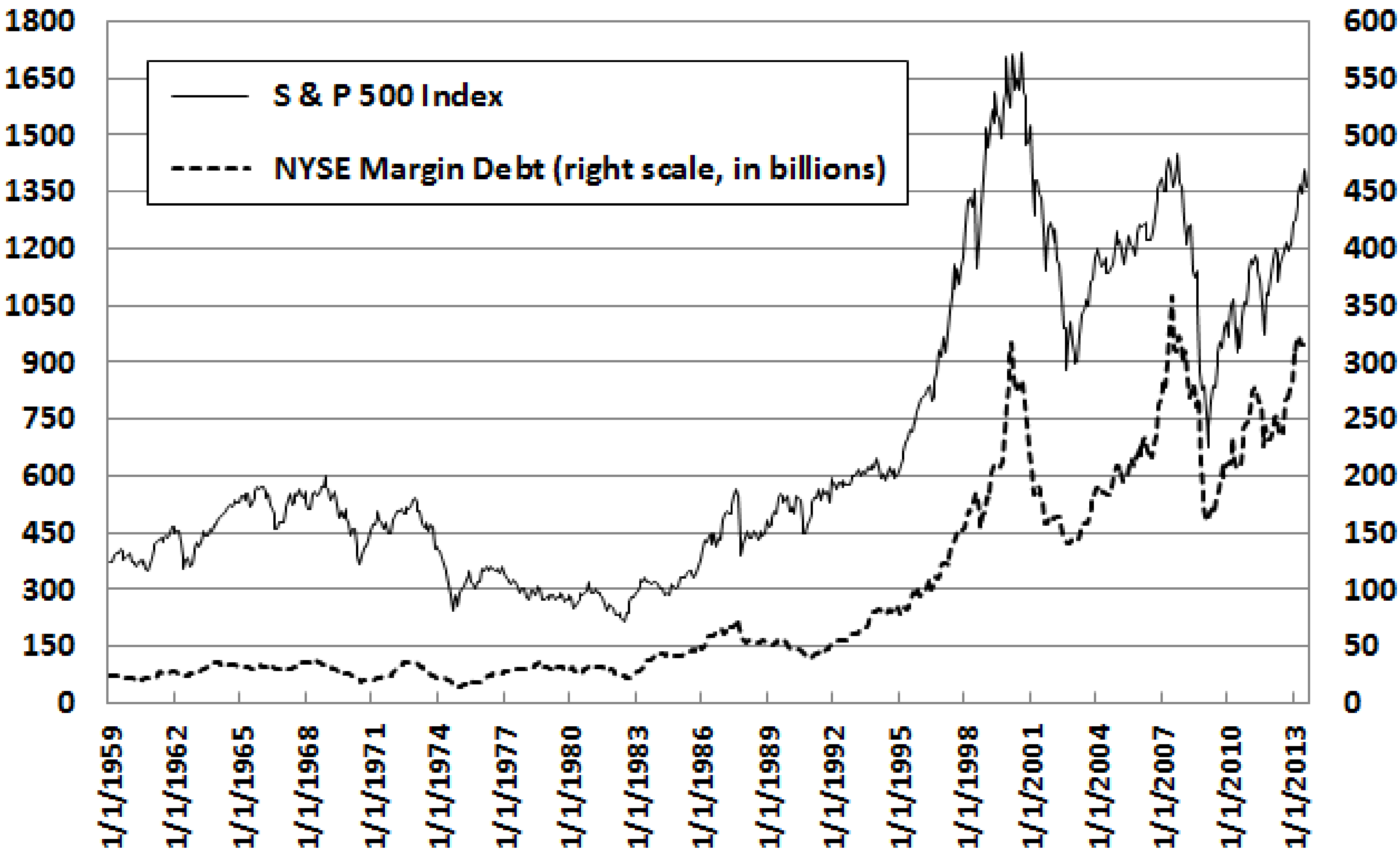


Housing Assets, Mortgage debt and Equity, 1920-1940. Decline in value against fixed debt was large (E:-1/3), less severe than in Great Recession (E:-1/2).



Proposition 2: Why Stock Market Crashes Do Not Cause Enduring Household-Bank Balance Sheet Damage

Margin Debt moves up AND DOWN with stock values; does not damage household-bank equity like housing declines



The Federal Reserve did not understand proposition 2 in 2005:

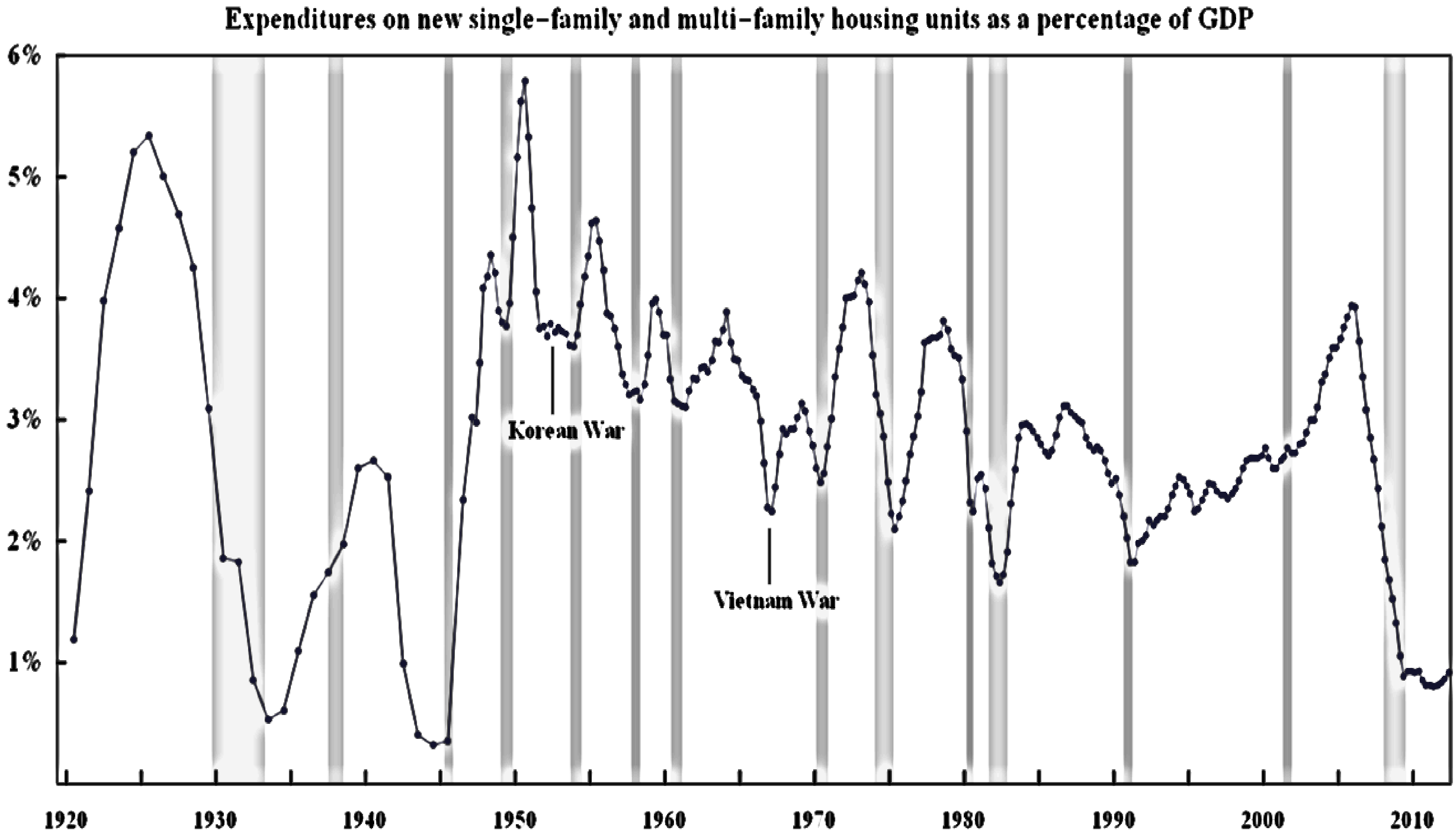
FOMC Conference on the housing bubble, 2005:

The question: Is there a bubble? The answer,

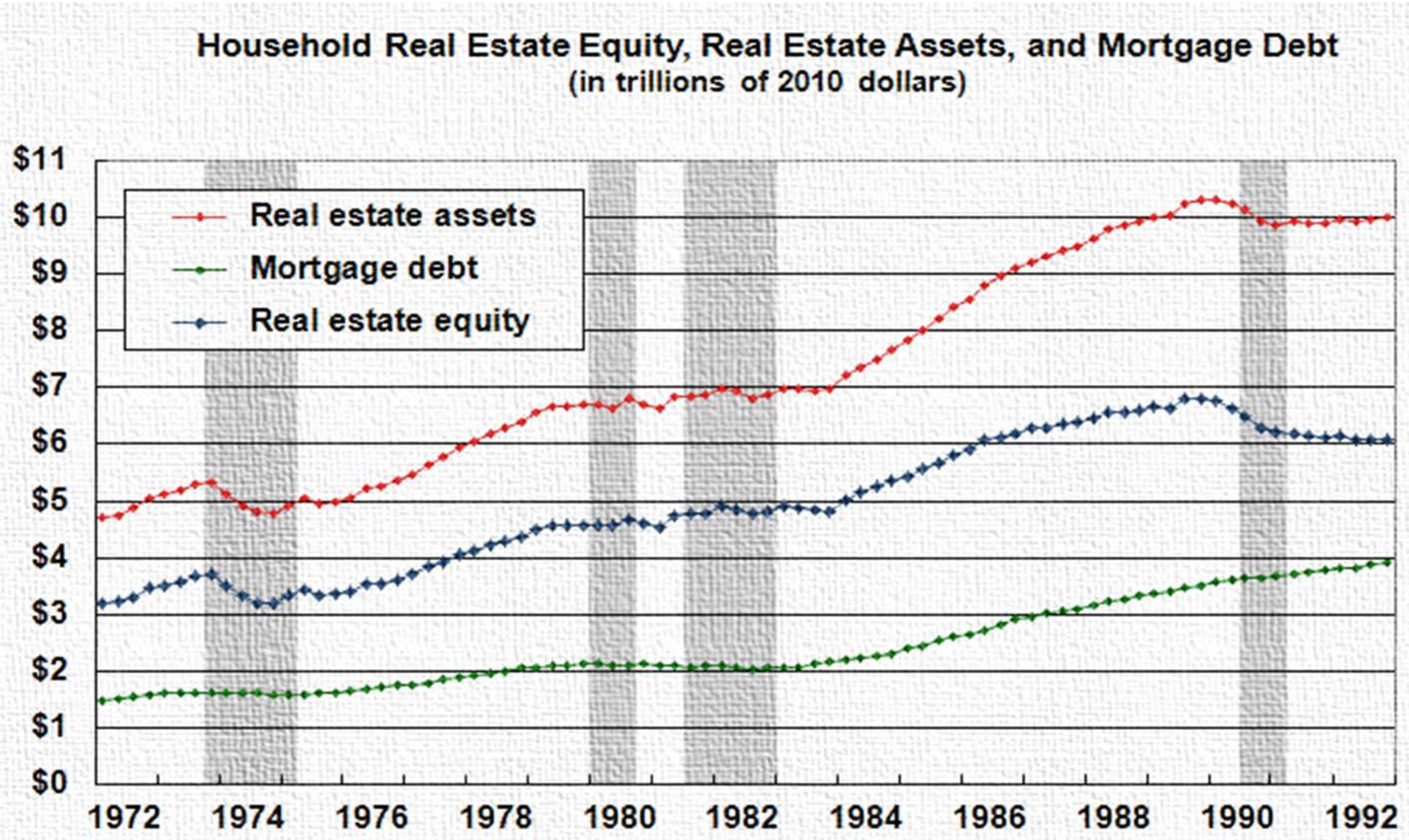
- YES, house prices have risen far in excess of income and rentals. Conclusion: although uncertain
- "…nevertheless, it seems clear the magnitude of the current potential problem is much smaller than, and perhaps only half as large as, that of the stock market bubble (dotcom market crash of 2001-2)." (Williams, 2005, pp. 17-18)

Proposition 3: The Ordinary Business Cycle is the Consumer Housing Cycle and Does Not Damage Balance Sheets

Housing construction, % GDP, since 1920: housing led in 11 of past 14 recessions; all GDP recoveries occur with housing; only Depression, Great Recession, were balance sheet crises.



The Typical Post WWII Recession: No Serious Damage to Household-Bank Balance Sheets



Proposition 4: How To Achieve Escape Momentum From Recessions With Large Numbers Of Damaged Household & Bank Balance Sheets?

Not with monetary expansion; monetary super-ease is inert for reviving a depressed economy; ”pushing on a string.”

Not by government deficit spending; fails for the same reason that monetary ease fails.

Why? Too many low, zero, and negative equity, balance sheets.

WWII spending was not the exception; by 1940 we had experienced 10 years of balance sheet repair; household equity returned to normal levels—home equity = 1929 level—and government spending restored as an effective stimulus.

Proposition 5: Recovery Through Bankruptcy and Default as a Balance Sheet Repair and Reboot Process (Sweden & FDIC)

- **bank mortgages marked to market;**
- **Banks recapitalize through private markets; downsize as required; zero out equity, bond hair cuts as needed; only prepaid insured deposits guaranteed, not investors. (Sweden's banks put through bankruptcy, early 1990s; also Finland; 489 banks failed at FDIC, 2008-2013).**
- **Why does allowing failed banks to fail foster recovery from balance sheet crises? *The return on investment and lending in new economic activity is undiluted by past claimants whose investments failed. Any dilution reduces the demand for new activity.***
- **Removes balance sheet barriers to lending, borrowing, resumption of normal household demand.**

Proposition 6: The Political Process Protects Incumbent Investors From Bankruptcy & Default—U.S. & Japan TBTF.

In U. S.

- **Carry bank mortgages at book value;**
- **Borrower makes full payment, if at all feasible;**
- **if not, lower payments by stretching the loan terms and lowering interest; otherwise foreclose or short sell house.**
- **Bail-out of BAC and C investors; shares sell for 75% of book value; reported profits good (but investors read "profit" as doubtful; compare WFC, shares 175% book).**
- **Recovery stalled; by Depression clock time, 2012 was 1934, when GNP grew 7.7 percent; slump worse then; but have we simply stretching out the years of lost output?**
- **Prediction difficult:** ***U.S. has no experience with massive downturns, bail-out 'cures,' and continued balance sheet damage.***

Japanese Form of TBTF

Japan: House prices peaked, 1990; fell 25 percent, by 1992; by 2004 had fallen 65 percent.

Government response: Allow banks to make “support loans” to distressed borrowers to enable them to continue to make their payments from 1993-2004; Banks did not book these de facto loan losses; stretched write-downs of loan losses (20% of GDP) over 12 years.

Objective: allow Japanese banks to offset their losses on bad assets with earnings from sound assets as those earnings were expected to arrive. But effect was also to dilute return to the financing of new economic activity.

Consequence: Japanese banks suffered from a 15 year decline in lending (minus 1.7% per year)

What is to be done?

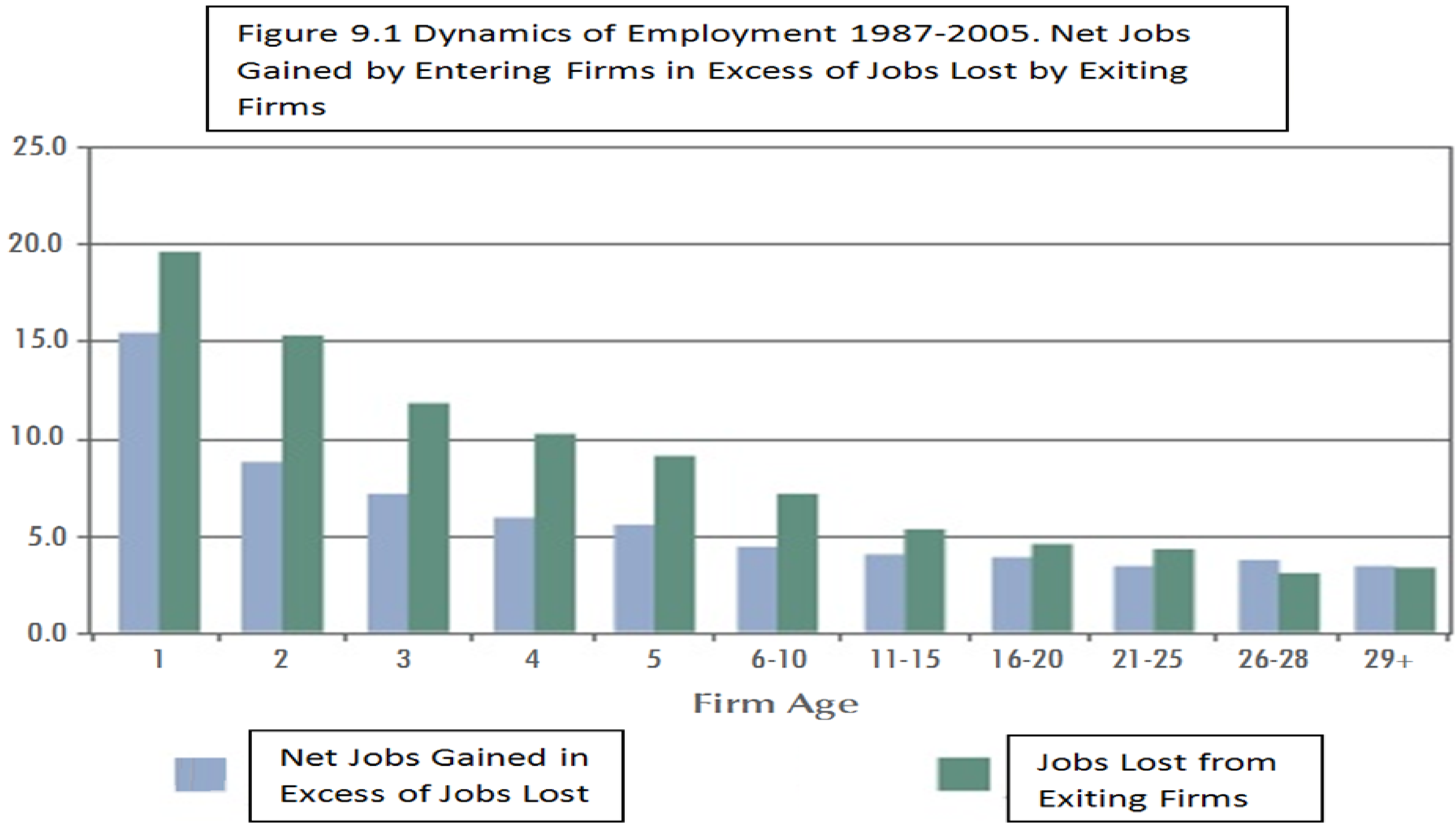
The public policy damage from preventing the bankruptcy of failed banks cannot be changed.

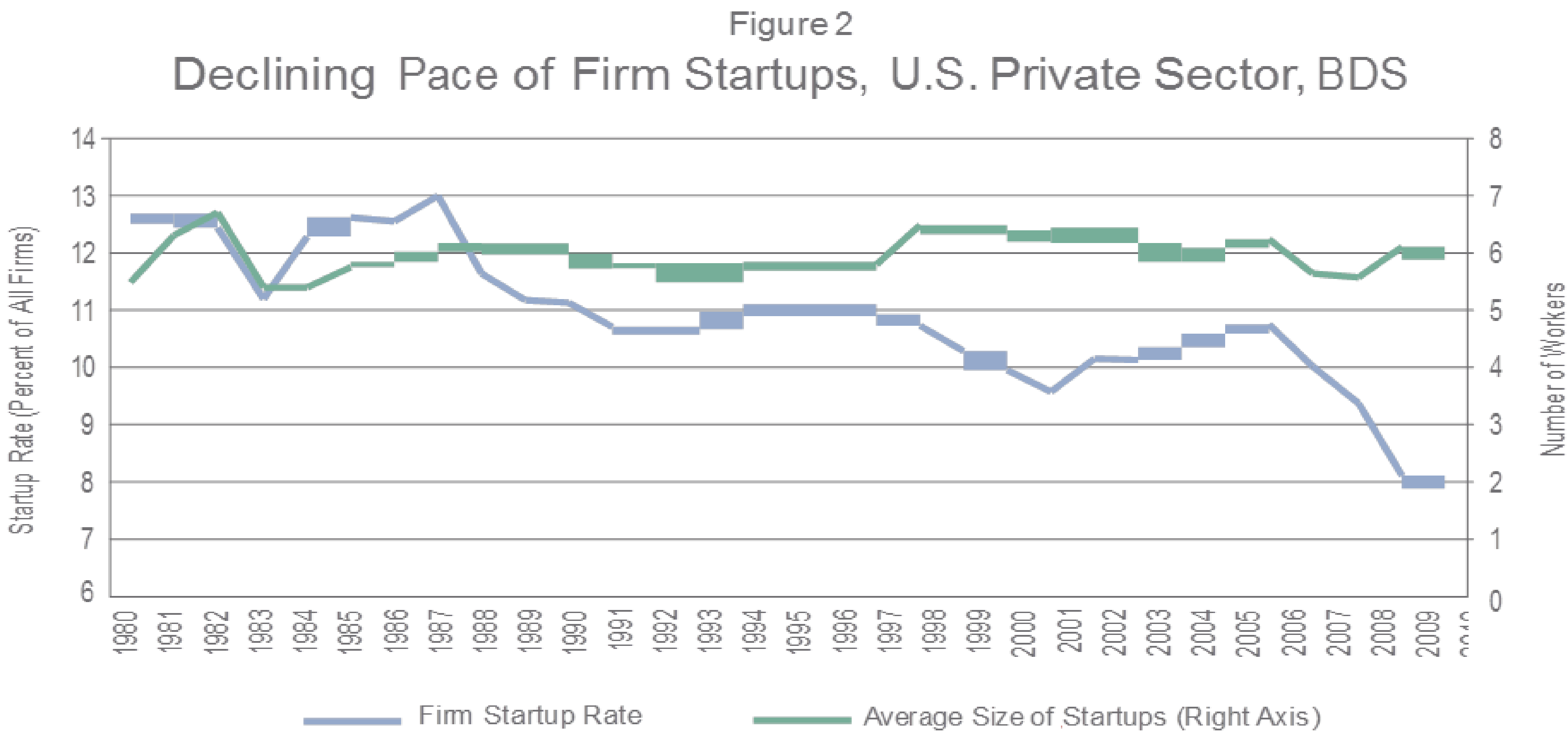
We can, however, ask if there are barriers that retard growth.

Young firms have historically been the engine of U.S. growth.

Young Firms and U.S. Growth in Employment (and Output).

(Source: Haltiwanger, et al (2009); Kaufman Census Bureau BDS)





From Haltiwanger, et al (2012) "Where have all the young firms gone" Kaufman Foundation, U.S. Census Bureau Business Dynamics Statistics

Proposal

- Make it easier to start new businesses.
- Eliminate the corporate income tax

THANK YOU