America’s Economic Challenge

By Martin Feldstein

Cambridge – With less than two months remaining before America’s presidential election, much attention is focused on the state of the American economy and the challenges that it will present to the next president.

We are in the midst of a financial crisis caused by the serious mispricing of all kinds of risks and by the collapse of the housing bubble that developed in the first half of this decade. What started as a problem with sub-prime mortgages has now spread to houses more generally, as well as to other asset classes. The housing problem is contributing to the financial crisis, which in turn is reducing the supply of credit needed to sustain economic activity.

The financial crisis is worsening as house prices spiral downward, owing to the increasing number of homes with negative equity, i.e., with substantial mortgage debt in excess of market values. Negative equity is significant because mortgages in the United States are generally “no recourse” loans. If a homeowner defaults, creditors can take the house, but they cannot take other property or income to make up any unpaid balance. Even in those states where mortgages are not “no recourse” loans, creditors generally do not pursue the assets or income of individuals who default.

We cannot be sure about how much further house prices will fall. Experts say another 15% decline is required just to return to the pre-bubble price path. But there is nothing to stop the decline from continuing once it reaches that point. The growing gap between mortgage debts and house prices will continue to increase the rate of defaults. Many homeowners who can afford to make their mortgage payments will choose to default, move to rental housing, and wait to purchase until house prices have declined further.

As homeowners with large negative equity default, the foreclosed homes contribute to the excess supply that drives prices down further. And the lower prices lead to more negative equity and therefore to more defaults and foreclosures. It is not clear what will stop this self-reinforcing process.

Declining house prices are key to the financial crisis and the outlook for the economy, because mortgage-backed securities, and the derivatives based on them, are the primary assets that are weakening financial institutions. Until house prices stabilize, these securities cannot be valued with any confidence. And that means that the that the financial institutions that own them cannot have confidence in the liquidity or solvency of potential counterparties – or even in the value of their own capital. Without this confidence, credit will not flow and economic activity will be constrained.

Moreover, because financial institutions’ assets were bought mainly with borrowed money, the shortage of credit is exacerbated by their need to deleverage. Since raising capital is difficult and costly, they deleverage by lending less.

This comes at a time when the increasing number of mortgage defaults has created a crisis for the quasi-government lenders Fannie Mae and Freddie Mac, forcing the government to take control of them. Their shareholders have been essentially wiped out, while holders of their bonds have been protected, which may cost American taxpayers hundreds of billions of dollars.

The macroeconomic weakness in the US now goes beyond the decreased supply of credit. Falling house prices reduce household wealth and therefore consumer spending. Falling employment lowers wage and salary incomes. The higher prices of food and energy depress real incomes further. And declining economic activity in the rest of the world is lowering demand for US exports.

The US Federal Reserve has, in my judgment, responded appropriately by reducing the federal funds interest rate sharply and creating a variety of new credit facilities. The low interest rate helped by making the dollar more competitive, but otherwise monetary policy appears to have lost traction because of the condition of the housing sector and the dysfunctional state of the credit markets.

The US Congress and the Bush administration enacted a $100 billion tax rebate in an attempt to stimulate consumer spending. Those of us who supported this policy generally knew that history and economic theory implied that such one-time fiscal transfers have little effect, but we thought that this time might be different. Our support was, in the words of Samuel Johnson, a triumph of hope over experience.

In the end, our hopes were frustrated. The official national income accounting data for the second quarter are now available, and they show that the rebates did very little to stimulate spending. More than 80% of the rebate dollars were saved or used to pay down debt. Very little was added to current spending.

So that is where the US is now: in the middle of a financial crisis, with the economy sliding into recession, monetary policy already at maximum easing, and fiscal transfers impotent. That is an unenviable situation, to say the least, for any incoming president.