Avoiding the Cliff:

Applying Lessons from the Great Recession to Today's Economy

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Executive Summary

Now in its 10th year, the current economic expansion is the second longest in American history, and the sustained economic growth has begot a strong economy; Gross Domestic Product will grow well above three percent in 2018, unemployment is below four percent, and wage growth is exceeding (modest) inflation.

Yet it pays to be cautious. Although most economists believe the economy will grow through 2020, continued expansion is not inevitable. In fact, an in-depth examination of the global economy reveals several weak points that could potentially threaten the current expansion.

Some of these threats have their origins in the previous downturn a decade ago. In many cases the policy responses of 2008 and 2009 merely patched over serious structural issues rather than solving them. Potential trouble spots include a collapse of the Chinese debt bubble, the long-term durability of the Eurozone and whether countries such as Italy and Greece can remain within it, and rising debt--both public and private--in the developing world as well as Western Europe.

There are also causes for concern domestically. Rising interest rates would put pressure on bond markets, which may soon reveal whether lending standards have become too lax a decade after the Great Recession. Higher interest rates would also exacerbate the slowdown in the housing market. Although housing debt is nowhere near the dangerous levels of 2007, the combination of high prices and rising interest rates is already slowing demand. The danger is that lenders will try to combat the slowdown by lowering credit standards, which could potentially raise housing prices beyond sustainable levels and crater the housing market again. There is some evidence that this is beginning to occur.

If a recession does arrive in the near future, policymakers have a lot less room to respond than last time. The current low interest rates give the Federal Reserve less room to provide a strong monetary boost and the government deficit, as well as the debt-to-GDP ratio, is much higher than in 2008, which complicates the delivery and efficacy of fiscal policy. Finally, the trust and institutional integrity of international financial organizations have been weakened, making it far more difficult to coordinate a global response to an emergency this time.

The current environment makes it especially important that policy makers monitor the situation to mitigate potential risks. In this context, it is worrisome that a decade later, important disputes over the distribution of liabilities, such as that between the Bank of America and Ambac, are still being litigated. Extended delay merely increases uncertainty in a time of distress and causes parties to worry about the worth of contractual provisions.

The Causes of the 2008-2010 Global Recession

It is unrealistic to expect that neither the United States nor the world will undergo another recession. It is, however, extremely important to do everything possible to minimize the occurrence of deep, prolonged downturns such as those that occurred in 1907, 1929, and 2008. These events proved to be extremely destructive; rather than just delaying growth, each one significantly weakened the underpinnings of the economy and resulted in sustained declines in growth as well as seismic changes in society.

Deep recessions have not been limited to the United States. In their book *This Time is Different: Eight Centuries of Financial Folly,*[1] Carmen Reinhart and Kenneth Rogoff document numerous instances of sustained economic downturns across the globe.

Although the perception is sometimes different, the global downturn that started in 2008 was exacerbated by fundamental imbalances in other parts of the world in addition to the subprime crisis that originated in the United States. These exacerbating factors included heavy public borrowing by EU members including Greece, Italy, Spain and Portugal, whose economies could not support high debt levels at rates that reflected their true market risk. Elsewhere, loose lending

[1] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly,* (Princeton University Press, 2009).

standards and rapidly appreciating prices led to housing bubbles in Iceland and Ireland, and smaller--but still significant--home price inflation throughout Europe. The Great Recession was a truly global phenomenon that went far beyond U.S. imbalances.

The Great Recession can also be viewed as the latest in a series of regional crises dating back to the 1970s. These include the Latin American debt crisis in 1982, the U.S. savings and loan collapse of the late 1980s, the collapse of the Mexican peso in 1994, the Asian crisis of 1997, and the implosion of LCTM in late 1998. Each of these events were exacerbated by an increase in highly liquid money pursuing high returns. The resulting rise in asset prices in turn encouraged a decline in lending standards. However, because these investments were liquid, they could flow out at the first sign of trouble--which they ultimately did, leading to a sudden rise in interest rates, fiscal insolvencies, and collapsing asset prices.

Some economists fear that the Chinese economy could suffer a similar fate, especially since there remains an ample supply of highly liquid money, which Ben Bernanke once referred to as a "global saving glut."[2] This ready supply of short-term lending has not been absorbed by long-term investments that typically outlast cyclical economic downturns but has instead been parked in U.S. government and other relatively safe debt earning a nominal rate of return.

The Flawed Response to the Crisis

By 2007 the structural imbalances that low interest rates, loose lending standards and high property prices had engendered meant that some sort of recession was probably inevitable, but it need not have been especially deep or prolonged. During the previous U.S. recession in 2001, the financial system suffered even larger losses from the dot-com bust and the terrorist attacks on 9/11, but these losses were quickly absorbed on the balance sheets and the global financial system never approached anything resembling a 2008-type meltdown. Although the recession lasted 8 months, the economy declined only 0.3 percent from its trough and unemployment topped out at 6.3 percent. In contrast, the Great Recession lasted 18

[2] "The Global Saving Glut and the U.S. Current Account Deficit, Remarks by Governor Ben Bernanke at the Sandridge Lecture, Virginia Association of Economists, Richmond, Virginia, March 10, 2005, https://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm.

months, during which GDP fell by more than five percent and unemployment reached ten percent.

The difference holds lessons for what policymakers can do today to prevent or at least minimize the impact of the next downturn. In each of the previous crises, a large supply of short-term liquidity encouraged banks to borrow large sums of short-term money, allowing them to increase their leverage. In addition, much of this debt (although not those connected with subprime mortgages in the United States) were in a currency different than the assets that backed them. Finally, bank finances were very opaque, so that when institutions such as BNP Paribas and Northern Rock required help, wholesale lenders suddenly realized that the problem was far worse than they had originally conceived it to be.[3]

Regulators could have done two things in response that would have mitigated the crisis. The first would have been to pre-emptively tighten credit limits to prevent the increase in leverage, the asset price bubbles, and the fall in lending standards that came to do so much damage.

Of course, anticipating financial crises is nearly impossible to do--both for regulators and investors. Alan Greenspan famously warned of "irrational exuberance" in December 1996, more than four years before the dot-com crash in 2000.[4] Similarly, Ben Bernanke's pronouncement of a global savings glut and the attendant problems it could create occurred roughly three years before the collapse of Bear Stearns. In both situations, the source of concern was a major contributor to the economic growth at the time.

A regulator trying to head off a financial crisis anticipates that its actions will create slower economic growth and a fall--or at least a sharp reduction in growth--in asset valuations. At the same time, convincing the populace--or politicians--that its actions prevented a potential calamity is well-nigh impossible. The Federal Reserve's current efforts to raise interest rates, motivated partly in order to give itself more room to lower them in a crisis, has received criticism not only from President Trump, but also from economists and others worried about prematurely slowing the economy and erasing the recent increases in worker salaries.

[3] Adam Tooze, "The Forgotten History of the Financial Crisis," *Foreign Affairs,* September/October 2018, vol. 97(5).

[4] Alan Greenspan, "Remarks at the Annual Dinner and Francis Boyer Lecture of the American Enterprise Institute for Public Policy Research, Washington, D.C., December 5, 1996, https://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm.

The second thing that regulators could have done to ward off a severe recession would have been to take steps to stave off a financial unwinding in which assets must suddenly be marked down and losses allocated and absorbed. Such a process is never simple but the general goal of such an action is to prevent a crisis of confidence that results in good borrowers being unable to obtain credit and the price of otherwise sound assets tumbling.

To prevent such an occurrence, the government should be prepared to lend unlimited sums of money, but only backed by good collateral and at a reasonably high rate.[5] The insistence on collateral allows the government to lend to anyone, without verifying whether they remain solvent. The relatively high rate has several purposes: First, it deters those who can still borrow on private markets. Second, it reduces political opposition by ensuring the government gets compensated for the service of being the lender of last resort.

The response to the 2008 crisis failed for several reasons. First, regulators lacked a full understanding of both the magnitude and the breadth of financial risks. Following the Great Moderation of the previous quarter century a perception increasingly took hold among regulators that recessions could be managed with their existing tools, and that bank runs and other examples of severe financial market crises were unlikely to happen again. Meanwhile, institutions such as Countrywide Financial Corporation had made tens of thousands of low quality and even fraudulent mortgages and then sold them on to private investors. Regulators had little idea who ultimately held title to these loans or how over-leveraged they were.

Second, it took regulators a long time to formulate responses that gave financial markets a modicum of assurance that they were on top of things. Officials at times appeared to be worried more about how to minimize the cost of any intervention than preventing the worst case from happening, a perspective doubtless resulting from an inability to grasp that a full-fledged financial collapse was a very real possibility.

Instead, they engaged in a series of actions that market participants viewed as ineffective. These included coordinated borrowing from the Federal Reserve and plans to purchase hard-to-value assets.

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[5] Walter Bagehot, *Lombard Street: A Description of the Money Market,* (New York: Scribner, Armstrong & Company, 1873), 197.

The International Outlook

Mark Twain reportedly remarked that while the past does not repeat itself, it does rhyme. While the U.S. financial market regulators have spent the last decade revamping our financial regulatory apparatus and conducting stress tests, the reality is that it is impossible to ensure against another crisis of confidence leading to another financial market collapse similar to what occurred in 2008. The world economy continues to be plagued with high public debt, underfunded public and private pensions, and a paucity of productivity growth throughout the developed world that precludes any hope of countries growing out of their predicaments.

These imbalances could create sudden threats to the global economy. For instance, following the 2008 recession the Chinese government averted its own crisis by injecting a massive amount of capital to prop up its banks and state-run enterprises while also financing multiple large construction projects. But by 2015 China's businesses had borrowed over $1.7 trillion in foreign currency. Its political leadership is hoping to maintain popular support by achieving some sort of "soft landing" that balances a tightening of credit standards with continued government support for capital projects. Meanwhile, a number of other developing countries (such as Turkey) have borrowed heavily in dollars or Euros and may have a limited ability to weather a combination of rising interest rates and a strengthening dollar.

Europe offers its own challenges to the post-Great-Recession economy. With a smooth exit looking less likely, the economic consequences of Brexit are increasingly uncertain, both for the United Kingdom and the European Union. The latter also faces its own internecine battles: Italy, Greece, and possibly Portugal appear increasingly reluctant to make the internal reforms necessary to conform to EU rules. It is unclear how the other members would respond to increasingly brazen refusals to comply.

Finally, geopolitical tensions, low oil prices, and the absence of effective U.S. leadership have increased political uncertainty in the Middle East as well.

The fraying of ties between the U.S. and E.U. and the ratcheting of global political tensions across the globe have weakened our international institutions and make a future multilateral intervention to head off some future financial crisis less likely. Adam Tooze, a financial market historian at Columbia University, has pointed out that the response to the 2008 crisis relied on a network of international institutions that successfully coordinated national policies and largely prevented destructive responses such as trade barriers and currency devaluations. Although the global economy remains deeply interconnected, consistent attacks by the current U.S. administration and others have increased the expectation that in a future crisis each nation will be left to fend for itself.[6]

The Domestic Outlook

On the surface, the American economy looks very strong. Annual GDP growth will likely exceed three percent for the first time since before the Great Recession and our unemployment rate is at a fifty-year low. The uptick in growth over the last few quarters has resulted largely from increased investor confidence, the tax reform stimulus, and increased regulatory certainty.

One concern economists have is that policymakers have less room to maneuver in the event of a serious downturn. To prevent a crisis of confidence market participants must believe that policymakers both can and will take effective actions to maintain trust and liquidity should the need arise. Both are in doubt. In response to the 2008 crisis, the Federal Reserve lowered its key interest rate by 4.75 percentage points in 15 months. With a current interest ceiling of 2.25 percent, it could not do that today.[7]

The scope for fiscal policy is also much narrower. Prior to the economic stimulus initiated by President Obama in 2009, the ratio of federal debt held by the public debt to GDP was 44 percent.[8] It is now at 78 percent and projected to reach 118 percent of GDP by 2036.[9] Although the current Administration has shown little hesitation to run large deficits, at some point financial markets will demand higher interest rates and greater fiscal restraint as a condition of lending it more money.

Housing and Financial Market Uncertainty

There are few signs of any immediate housing crisis, but a decade after the collapse there are signs that lenders are responding to higher interest rates by

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[6] Adam Tooze, "The Forgotten History of the Financial Crisis.

[7] Open Market Operations, https://www.federalreserve.gov/monetarypolicy/openmarket.htm.

[8] Congressional Budget Office, *The Budget and Economic Outlook: 2018-2018,* 145, https://www.cbo.gov/system/files?file=115th-congress-2017-2018/reports/53651-outlook.pdf.

[9] Congressional Budget Office, *The Long-Term Budget Outlook Under Alternative Scenarios for Fiscal Policy,* August 2018, 3, https://www.cbo.gov/system/files?file=2018-08/54325-LTBO_AFS.pdf.

reducing down payments and lending standards to maintain volume and profits.[10] Both home construction and sales have been falling for the much of this year.

There are some signs that the market may achieve something akin to pre-crisis normalcy in the future. Housing credit scores currently seem sound; payment-to-income (PTI) ratios above 50 are almost nonexistent today, but they comprised as much as 20 percent of the market before 2008. PTIs above 40 have fallen from over 30 percent of all loans in 2008 to 5 percent today, and show no signs of increasing.[11] The government sponsored enterprises once again dominate the securitization market, with the share of private label securitizations having fallen roughly 45 percent since the pre-2008 peak.[12] Although builder sentiment has been steadily falling for the past year, it has done so from an all-time high established in December 2017, and it remains well above 50, the level that indicates continued expansion.[13]

The most pressing problem in the housing market these days is a lack of affordability. The United States has constructed fewer new homes per household over the last decade than at any other period since World War II.[14] Housing starts have been declining for the better part of a year, which most attribute to higher interest rates and the fact that the 2017 tax reform reduced the impact of tax breaks for owner-occupied housing. In several cities with the hottest job markets, political exigencies and geography constrain construction. Even when new projects are approved, high land prices and high regulatory costs push builders toward higher-end projects. Employment in the construction industry remains well below its pre-crisis levels as a result.

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[10] Kenneth R. Harney, “Signs Mortgage Lenders are Easing Their Standards,” Boston Herald.com, November 8, 2018, https://www.bostonherald.com/2018/09/09/signs-mortgage-lenders-are-easing-their-standards/; Michelle Lerner, “Many Lenders are Loosening Requirements for Prospective Home Buyers,” *The Washington Post*, February 22, 2017, https://www.washingtonpost.com/realestate/many-lenders-are-loosening-requirements-for-prospective-home-buyers/2018/02/22/5196ac7c-f006-11e7-b390-a36dc3fa2842_story.html?utm_term=.7a2c075290a1.

[11] Josue Cox, “Drivers of the Great Housing Boom-Bust: Credit Conditions, Beliefs, or Both?” (National Bureau of Research Working Paper No. 25285) November 2018), 25.

[12] Id., 27.

[13] Sarah Chaney, “U.S. Home Builder Sentiment Posted Steep Decline in November,” *The Wall Street Journal,* November 19, 2018, https://www.wsj.com/articles/u-s-home-builder-sentiment-posted-steep-decline-in-november-1542639600?mod=djemRTE_h.

[14] Laura Kusisto, “The Next Housing Crisis: A Historic Shortage of New Homes,” *Wall Street Journal,* March 18, 2018, https://www.wsj.com/articles/american-housing-shortage-slams-the-door-on-buyers-1521395460?mod=article_inline.

The National Association of Housing and Redevelopment Officials estimates builders will construct fewer than 900,000 homes this year, well below the 1.3 million needed to merely replace those that are torn down.[15] The National Association of Realtors reports that the inventory of new and existing homes hit its lowest level on record in the 4th quarter of 2017.[16] There has been little inventory change since that time.

Another worrisome sign in the housing market is that borrowers take cash out in a large portion of refinanced homes. The prolonged period of historically low interest rates allowed many homeowners to refinance at lower interest rates, saving them hundreds of dollars per month. The upsides are that these borrowers can more easily make continued payments and that few existing homeowners can lower their payments by refinancing now. Although 80 percent of borrowers who refinanced in the 3rd quarter of 2018 took some cash out, the $14.6 billion in equity they pulled out is well below the $80 billion quarterly average for 2007.[17]

Rising interest rates will make both construction and purchase loans more expensive. Freddie Mac reports that 45 percent of the loans it buys are to first-time buyers.[18] Higher interest rates have a greater impact on these borrowers. One analyst prognosticates that when interest rates hit five percent the number of homeowners qualifying for and benefitting from a refinance will shrink to 1.55 million, down 64 percent from the start of the year.[19]

Finally, house prices have been rising faster than wages for several years. Lower interest rates made up for much of this difference over the last decade, but recent rate increases erased that calculus. The Case-Shiller national index of home prices rose at an annual rate of 5.24 percent over the last five years and is now above its 2007 level, while real median income rose by less than half that amount, according to the Census Bureau.

Given these headwinds, the current slowdown in housing is likely to continue. This is less likely to affect the broader economy since housing is a smaller portion of the

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[15] Id.

[16] Id.

[17] Ben Eisen and Christina Rexrode, "Borrowers are Tapping Their Homes for Cash, Even as Rates Rise," *The Wall Street Journal,* November 25, 2018, https://www.wsj.com/articles/borrowers-are-tapping-their-homes-for-cash-even-as-rates-rise-1543159864?mod=djemRTE_h.

[18] Laura Kusisto and Christina Rexrode, "Mortgage Rates Fast Approaching 5%, a Fresh Blow to Housing Market," *The Wall Street Journal*, October 11, 2018, https://www.wsj.com/articles/mortgage-rates-fast-approaching-5-a-fresh-blow-to-housing-market-1539266400.

[19] Id.

economy than it was before 2008. Nevertheless, another sustained decline in home prices would undoubtedly impact growth. It is worth noting that a large number of today's originators of new mortgages are new entrants and have never been through a down market. The chief operating officer of Ginnie Mae recently remarked that "There are issuers that really want to make their profitability targets. The only way to do it is to convince borrowers to take cash out of their house."[20] Lowering lending standards would be another way to boost profits for these originators, and the degree to which new regulation can deter such behavior has not yet been tested.

A recent paper by Josue Cox and Sydney Ludvigson shows that lending standards have a large and sustained effect on housing prices, accounting for between 26 and 49 percent of the variation in house prices.[21] Lower credit standards could be justified as creating homeowner wealth and expanding the number of homeowners. It would work right up until the next credit crunch.

The Task for Regulators

In the current climate, scarcely a decade removed from the financial crisis of 2008, it is especially important for regulators to be alert to problems in financial markets. If regulators cannot prevent recessions, they can at least try to prevent them from causing a credit crunch that metastasizes into a broader lack of confidence in the system. One of the most effective ways to accomplish this would be to encourage a write-down of losses from the last recession. Unfortunately, this cannot be done until the legal system has finally assigned those losses.

The financial market ambiguity resulting from legal uncertainty makes the protracted litigation between Bank of America and Ambac--one of the most significant cases yet to be resolved--potentially problematic. Ambac issued insurance on a large number of securities backed by thousands of mortgage loans. The insurance allowed the securities to obtain high credit scores irrespective of the quality of the mortgages backing them. It also allowed the mortgage originators to give borrowers lower interest rates. Some of these mortgages were originated by Bank of America but many more were issued by Countrywide, which Bank of

[20] Ben Eisen and Christina Rexrode, "Borrowers are Tapping Their Homes for Cash, Even as Rates Rise."

[21] Josue Cox and Sydney C. Ludvigson, "Drivers of the Great Housing Boom-Bust: Credit Conditions, Beliefs, or Both?".

America purchased in 2008. As a condition of insuring the securities, Ambac required both Bank of America and Countrywide to make representations about the quality of the loans backing them.

Soon after housing markets collapsed it became obvious that parts of the mortgage market had been characterized by widespread fraud. Ambac ended up paying investors an estimated $2 billion to cover securities backed by Countrywide and Bank of America mortgages.[22] It has initiated four suits based on separate securities against Bank of America, three of which concern loans primarily made by Countrywide. It alleges that a high portion of the underlying mortgages failed to meet the underwriting standards guaranteed by the warranties. Ambac also alleges that Bank of America essentially stripped Countrywide of its assets soon after purchasing it.

In August of 2014, Bank of America reached a settlement with the Department of Justice to the tune of $16.65 billion for financial fraud leading up to and during the financial crisis. In the settlement's statement of facts, the bank acknowledged that it sold billions of dollars of residential mortgage-backed securities (the type that Ambac insured) without disclosing to investors key facts about the quality of the securitized loans. Given that Bank of America has already admitted guilt and paid tens of billions of dollars in fines for these and other securities, it would seem to have little legal basis for opposing a settlement.

It is unsettling that major cases like this can drag on ten years after the crisis. Until we adjudicate a clear allocation of the liabilities, investors cannot have a clear picture of the health of individual institutions or predict their potential liabilities in the housing finance market, which dampens activities. The legal morass also suggests to market participants that it may be difficult or impossible to enforce either insurance claims or warranties in the future.

We know that to mitigate the impact of future crises, it will be vital to mark down assets quickly and assign losses to the parties that must ultimately bear them. While regulators cannot override parties' rights, they can strongly encourage negotiations to settle claims and press for quick judicial attention when cases are litigated. They can also make institutions set aside adequate reserves to cover

[22] William T. Russell Jr. and Lynn K. Neuner, "A Review of 'Ambac Assurance Corp. v. Countrywide Home Loans,' *New York Law Journal*, July 17, 2018, https://www.law.com/newyorklawjournal/2018/07/17/a-review-of-ambac-assurance-corp-v-countrywide-home-loans/.

likely losses. Such actions, together with the quick injection of unlimited capital on sound collateral, would have greatly mitigated the Great Recession.

Recessions are difficult to forecast, and they are not always easy to diagnose ex post, either. We do know, however, that it is always valuable to have as much legal and regulatory clarity in financial markets as our regulators can provide. In the last decade the alphabet soup of regulators have striven to accomplish as much of this as has been feasible.

However, there is still more than can be done in this regard, especially in the housing market, which remains in a torpor a decade after the crisis.