Crises and the recent recession

Tatom, John

Networks Financial Institute at Indiana State University

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John A. Tatom

Abstract
The United States economy has suffered over the past four years from crises in mortgage foreclosures and in financial markets, as well as a long recession that some have referred to as the Great Recession. The links between these events, or more broadly the causes, extent and effects of these developments, are sources of continuing controversy and uncertainty. This paper attempts to disentangle the links between the mortgage foreclosure crisis, the financial crisis, a possible banking crisis and the Great Recession, at least in terms of timing, and also to provide an alternative view to the conventional wisdom, especially for the link of crises to the recession.

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The United States economy has suffered over the past four years from crises in mortgage foreclosures and in financial markets, as well as a long recession that some have referred to as the Great Recession. The links between these events, or more broadly the causes, extent and effects of these developments, are sources of continuing controversy and uncertainty. The foreclosure crisis began in late 2006 when housing starts and housing prices peaked and began a steep decline. The broader financial crisis has been variously dated from the beginning of the foreclosure crisis, to spring 2007, when several hedge funds and single issue mortgage and bond insurers either failed or had their own credit quality seriously downgraded; to summer 2008, when Bear Stearns failed and Fannie Mae and Freddie Mac were put into government conservatorship; or to September 2008, when Lehman Brothers and Merrill Lynch failed, Wachovia was forced into a takeover ultimately by Wells Fargo, and American International Group (AIG) almost failed before a federal and Federal Reserve bailout injected some $180 billion into the firm through a variety of loans and equity infusions. Regardless of when it began, it appears to have been a follow-on to the mortgage foreclosure crisis because the failures were largely associated with the direct holdings of mortgages or mortgage backed securities.

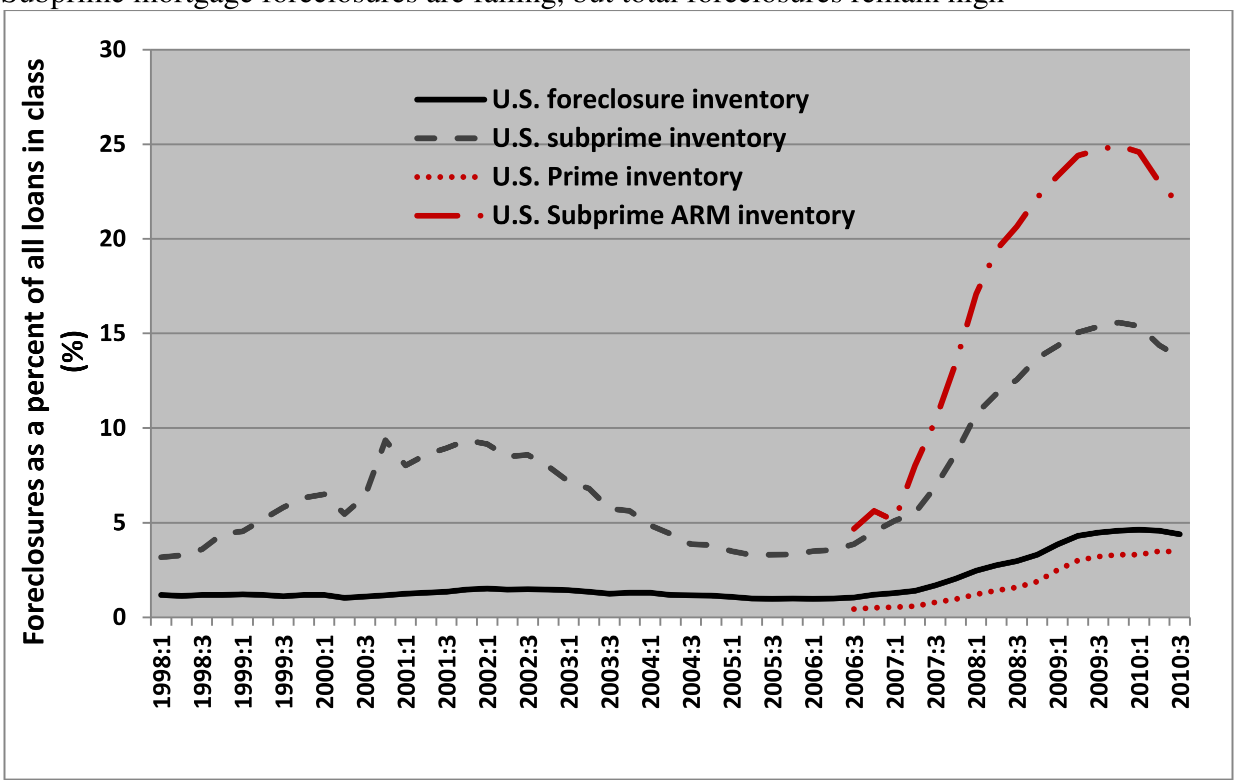
The financial crisis presumably ended in late 2008 with some return to normalcy, or at least an end to mortgage related failures of investment banks. Some would argue, however, that the financial crisis has not ended because the market for securitized lending has not recovered. The recession began in the fourth quarter of 2007, a year or more after the onset of the mortgage foreclosure crisis and before the financial crisis began. The recession ended in mid-2009, after the financial crisis, but well before the end of the mortgage foreclosure crisis.

The Changing Face of the Mortgage Foreclosure Crisis

Initially, the surge in foreclosures was driven by foreclosures on adjustable rate, subprime loans. Many of these borrowers came late to the mortgage interest rate cycle as the mortgage rate outlook was deteriorating and informed borrowers knew that adjustable rates loans were set to re-price upward, making marginal loans unaffordable. Some of these borrowers were more speculative and took out such loans anyway, planning to sell their houses and repay the loans before they were re-priced. When the recession began, the situation changed, as individuals with relatively high credit ratings began to lose their jobs and income, and, as a result, enter the foreclosure process.

Chart

Subprime mortgage foreclosures are falling, but total foreclosures remain high



Source: Mortgage Bankers Association

The chart shows the explosion in mortgage foreclosures for various types of mortgages from 1998 to the third quarter of 2010, except for adjustable rate subprime loans and prime loans series which are shown here beginning in the third quarter of 1996. The foreclosure inventory includes all mortgages at any stage of the foreclosure process. The mortgage crisis does not appear to have caused the recession because the recession did not begin until more than a year after the beginning of the mortgage crisis and it ended eighteen months ago, despite the continuing foreclosure crisis.

Were the Mortgage and Financial Crises Part of a Banking Crisis that Caused the Recession?

While the mortgage crisis did not cause the recession, it certainly did create, or morph into, the financial crisis. The financial crisis also did not cause the recession, but it and the mortgage foreclosure crisis could have made the recession worse. The mortgage crisis arose because of the growth of subprime mortgage and securitization products developed by mortgage bankers and investment banks, largely outside the regulatory structure that governs bank holding companies and commercial banks or commercial banking laws. Significant pressure from Congress, supported by mandates and federal subsidies to foster homeownership, accelerated the development and growth of subprime products.

As a result of the growth in home ownership and especially the growth of subprime mortgage assets, incentives were created for investment banks to develop financial products to leverage and manage their mortgage portfolios. These products were often created by nontraditional companies and thus marketed outside of traditional regulatory structures. These new products included subprime-based mortgage backed securities, collateralized debt obligations, collateralized loan obligations, auction rate securities and credit default swaps. While some of these products were sound, many were complex and confusing, creating a misunderstood risk profile. During the crises, the large failures of institutions occurred among non-bank financial conglomerates such as Bear Stearns, Lehman Brothers, Merrill Lynch and American International Group (AIG). In short, the mortgage and financial crises were the result of poor regulation of new financial products created largely outside the traditional bank regulatory structure.

One of the ironic policy responses of the financial crisis was the notion that it was a banking crisis. The Treasury secretary and the Chairman of the Federal Reserve teamed up to convince Congress of precisely this point and to pass the Troubled Asset Relief Program (TARP), a $700 billion program, originally intended to purchase troubled assets from supposedly failing financial institutions. TARP began by forcing banks and a few non-bank financial institutions to accept government funds without public evidence that they were confronting any meaningful liquidity or solvency problems. Most of the banks paid back these funds as soon as they were allowed. In the end, the program was used to inject about $386 billion into capital of firms, but only $245 billion of that went into banks, $169 billion was paid back by the end of the program in October 2010 and only about $20 billion is expected to be lost due to failure of commercial banks. The rest of the disbursements and losses of up to $30 billion will come from loans and capital injections to automobile companies and AIG. The notion of a banking crisis requiring massive bailouts of bad assets of the largest commercial banks was never justified.

Another perspective on whether there was a bank-induced financial crisis is that the failure experience of depository institutions (banks and thrifts) has not risen to the level of the last real crisis, the savings and loan (S&L) crisis of the late 1980s and early 1990s. In a new broad historical review of financial crises, Carmen Reinhart and Kenneth Rogoff (2009) refer to the S&L crisis as a "bank-centered financial crisis" and they include it in their comparison of the subprime crisis to such crises. It must be noted that they use the term "milder," and not their terms "severe" or "systemic," in referring to the

S&L crisis, and they conclude that the subprime crisis was worse than other banking crises in advanced countries or than the five crises that they call the "Big Five" severe and systemic crises. Certainly this suggests that the subprime crisis was the worst since at least Great Depression, but one natural indicator that Reinhart and Rogoff do not review, the number of bank failures, suggests otherwise.

In 2008-09 there were 165 failures (there were only three in 2007, the first year of the crisis), and it is likely that there will be about 160 failures in 2010. But a total of 330 or so failures for 2008-2010 pale in comparison with the over four times larger number during the worst three years of the S&L crisis (1412 in 1989-91) or with the full 13-year period of elevated bank failures from 1981-93, when there were 2,335 failures, seven times as many as are likely in and following the recent subprime/financial crisis. Two of the largest thrift failures on record occurred during the recession, but bank failures have generally been much smaller than in the last banking crisis. At least for this indicator of banking crisis, the recent mortgage and financial crisis is hugely dwarfed by the so-called mild S&L bank-centered financial crisis.

Whether there was a banking crisis is important because Reinhart and Rogoff find that banking crises lead to very long periods of recession and recovery, much longer than the six quarters of the recent recession and six quarters of recovery. Their study of crises suggests that the real economic effects of a recent crisis would last far longer, supporting the notion of a "double dip" recession with the economy slumping back into recession and subsequently experiencing very slow growth for several years. Carmen Reinhart and Vincent Reinhart (2010) recently argued that even severe economic dislocations over the past 75 years show the same very slow recovery and subsequent slow growth as banking crises. The evidence of the past six quarters, though limited, does not support such a dire view of the prospects for the economy.

There are other reasons, beyond the mortgage foreclosure crisis that could have caused the Great Recession. For example, there were large surges in energy prices in late 2007 and in the summer of 2008 that were larger than the energy price increases before the two earlier great recessions in 1973-75 and 1981-82; these recessions lasted only two months less than the recent recession. In the latest recession, the unemployment rate reached 10.2 percent, which was lower than the peak 10.8 percent reached at the end of 1982. One of the most important recession indicators is the sharp slowing in monetary growth leading up to the recession. By the end of 2007 when the recession began, the monetary base, a measure of Federal Reserve actions to influence monetary aggregates, spending and economic activity, had slowed to 1.4 percent over the previous year, insufficient to support the existing inflation rate, not to mention normal economic growth. Subsequent monetary stimulus pushed this growth, after removing the sterile surge in excess bank reserves, to 12.1 percent over the next year. Unfortunately, the latter measure slowed to a 3.6 percent rate in August 2010.

The mortgage foreclosure crisis and its related financial crisis, may have contributed to the recession in its worst phase at the end of 2008 and early 2009, but dramatic expected shifts in economic policy could equally have explained the extreme recession developments from October 2008 to June 2009. Many analysts believe that the financial crisis was a banking crisis and as such is likely to have led to an extended recession, now including a "double dip," and relatively slow growth for several years. The continuing recovery and bank failure evidence do not support that view, however.

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