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HOUSING SLUMP AND SUBPRIME MORTGAGE CRISIS POSE SERIOUS DANGER TO U.S. ECONOMY, NEW LEVY INSTITUTE STUDY SAYS

Scholars Suggest Econometric Models May Not Capture Full Extent of Impact

ANNANDALE-ON-HUDSON, N.Y.—After months of mixed economic signals, the recent selloff on Wall Street makes clear that the slowdown in housing, collapse of the subprime mortgage market, and high energy prices are beginning to impact the broader economy. While some policymakers and analysts continue to assert that the subprime problems are limited and unlikely to spill over into the broader economy, a new report from The Levy Economics Institute of Bard College argues that the dizzying array of new financial products that fueled the subprime mortgage boom make it difficult to predict the full impact on household spending and the larger economy. In their Public Policy Brief, *Cracks in the Foundation of Growth: What Will the Housing Debacle Mean for the U.S. Economy*, Levy Institute President Dimitri B. Papadimitriou and Research Scholars Greg Hannsgen and Gennaro Zezza suggest that the housing and subprime fallout could hamper economic growth, generate social dislocations, and possibly lead to a full-blown financial crisis.

"The stage has been set for very serious and widespread economic difficulties, which may have begun to unfold," write Papadimitriou, Hannsgen, and Zezza. The scholars argue that potential for a real estate-driven economic crisis hinges on two recent financial developments: "securitization" of the mortgage market, whereby financial institutions that originate mortgages often do not bear the risk of default; and the greatly expanded use of subprime and "exotic" mortgages, such as those that feature no down payment, offer below-market "teaser" rates, or waive proof of income. Regarding securitization, the scholars stress that there is "no complete accounting of exactly who is exposed and to what extent, since hedge funds and the like are not as heavily scrutinized by regulators as

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traditional financial intermediaries, such as banks." As for lending practices and the general trend toward higher loan-to-home value ratios, the authors see a dangerous situation in which lightly regulated lenders have been taking undue risk while securing high commissions and short-term profits.

Using the Levy macroeconometric model, the scholars estimate that falling home prices will, at a minimum, create a drop of about 0.9 percent in household expenditure in the long run, and about 0.4 percent by the second quarter of 2007. They stress, however, that estimates of the marginal effect of one variable on another may not fully capture certain synergies and positive feedbacks that come with any major recession or financial crisis. "For example, a weakening home market may prevent financially distressed households from refinancing their homes, which would lead to foreclosures, which would in turn add supply to the market, pulling prices down further," the authors write. "Add to the mix variables such as job losses, defaults in other subprime credit markets, tightening standards for obtaining loans, and bankruptcies of financial institutions, and one can concoct scenarios that seem plausible but that cannot be understood simply in terms of an econometric estimate of the marginal effect of one variable on another. No one can be sure that such a scenario will occur or how serious it might be, but the possibility is there."

Many in the financial sector have defended the innovations in mortgage lending as part of a market-driven flowering of innovations that bring benefits to the economy and society, especially in making credit available to those who lack collateral and connections. Papadimitriou, Hannsgen, and Zezza assert that, while borrowers may have more choices and enjoy easier terms, the social costs of foreclosures will be borne by the very people who have apparently been the beneficiaries of democratization. "Subprime borrowers do not benefit when they take out loans they simply cannot afford, while mortgage bankers reap commissions and some company insiders exit with millions of dollars in profits from timely stock sales," they write. Viewing the housing and subprime debacle in the context of Hyman P. Minsky's financial fragility hypothesis, the Levy scholars' greatest concern is that the current situation represents the beginning of the downside of a classic boom-bust cycle. "The Minskyan view holds that the increasing availability of credit and proliferation of new financial products represents the unsustainable upward phase of a potentially unstable cycle," the scholars write. "According to this view, when the inevitable decline occurs, easy credit will no longer be around to cushion the impact, and we will all be reminded that the cycle is a brutal reality, and that financial innovations have both costs and benefits."

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