

Why They Call It the Dismal Science

*Everything you need to know about the mortgage crisis
in three economics buzzwords.*

BY IRWIN M. STELZER

Externalities. Information asymmetry. Moral hazard. Understand those three bits of economists' jargon, and you can be a do-it-yourself housing- and mortgage-market policymaker. Or at least you can thread your way through the competing proposals of conservatives—who want the government to keep hands off these markets, and let improvident borrowers and lenders swing in the wind—and interventionists who want to help those of their poor (think unemployed in Michigan, and large numbers of blacks and Hispanics) and almost rich (think suburban New York and California) constituents who are having trouble making their mortgage payments.

Externalities are the economist's version of the military's collateral damage. Externalities happen to innocent bystanders. Information asymmetry, another economist's favorite, refers to what happens in a market when one party to a transaction, usually the seller, inevitably knows a lot more about the product than the buyer. Moral hazard is the risk we run when we bail someone out of trouble he could have avoided, encouraging others to repeat the greedy, stupid, or excessively risky behavior. These definitions are not precise enough to satisfy academics, but are good enough for policy work.

It doesn't take a policy wonk to know that externalities abound in both the housing and mortgage markets. Foreclose on one house on a street, and the value of all the others, including those owned by perfectly solvent families, declines. During the foreclosure period of several months the occupant has no incentive to maintain the property; as Larry Summers pointed out in another connection, no one ever washes a rented car. While the eviction process

is being completed, the house is often stripped of its sinks, aluminum siding, and everything else that can be sold. The grass is uncut, and even if the bank, now the unhappy owner, tries to keep up appearances, it generally cannot. Banks make rotten housekeepers.

As a result, the neighborhood declines. Other homeowners, watching the value of their properties spiral downward, and the neighborhood become tackier, attempt to flee. For-sale signs proliferate. Property values drop further. Foreclosures rise. Innocent bystanders, perfectly prudent borrowers, are caught in a trap not of their own making. The policy question then gets complicated. It is not, "Do we try to help someone who borrowed too much from a lender who should have known better?" It becomes, "Is it good public policy to shield people from the external effect of the improvident action of others?"

So, too, in the credit markets. Foolish lenders find that the loans they made will not be repaid. Too bad, is the first reaction. But because no one is able to separate bad loans from good in many of the securities in which they are embedded, all lending screeches to a halt, creating problems for businesses with credit quality as good the day after the collapse of the subprime mortgage market as it was the day before. The banks that made the loans face huge write-offs, the price of their improvidence; their ability to lend to even the best borrowers declines with the shrinking of the asset side of their balance sheets. Help (or bail out) the improvident lender and you create moral hazard—a signal to others that such behavior will have no adverse consequences; refuse to help, and innocent bystanders by the score pay the price for a "crime" they did not commit. Factories do not get built; jobs do not get created; promising new enterprises don't get off the ground.

The problem is further complicated by information asymmetry. The seller of mortgages knows a lot more about what he is selling than does the home buyer/borrower. This is especially true in the subprime market. No good to rail against the borrower for his or her ignorance. Information

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asymmetry is and will remain an enduring fact of life. In some cases, that is offset by the seller's need to—another bit of economists' jargon—preserve his reputational capital, better known to the old-fashioned as his good name. But the mortgage broker will never see this particular borrower again, who is anyhow unlikely to realize that he has been taken advantage of in time to warn off others. Worse still, that broker has no long-lasting connection with the mortgage he has sold. That risk is sold off to buyers who are assuming they can package the loan with others of varying quality, and resell the package to still other buyers who are afflicted with—that's right—information asymmetry, known at this stage in the chain as a lack of transparency. Buying a pig in a poke is an earthier way to put it.

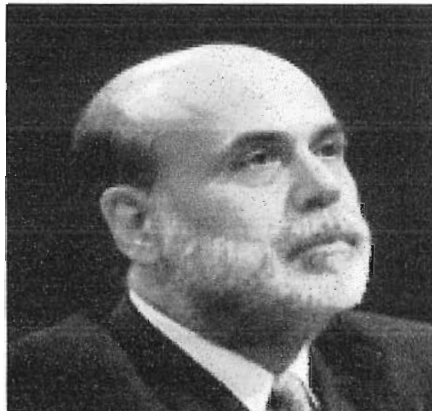
Does the government have a role to play in any of this? The “moral hazard fundamentalists,” as Summers calls them, say no. Do anything to ameliorate the pain of the dispossessed, or of the lender left holding the bag, or of any other party to these transactions, and you only invite repetition of the practices that got us into trouble in the first place.

Which brings us to Ben Bernanke and the Federal Reserve Board's monetary policy gurus. Everyone agrees that if a recession is looming, or some shock to the financial markets has caused a credit crunch, the Fed should cut interest rates to stimulate investment and consumption. And everyone agrees that if the opposite circumstance prevails—if inflation is rearing its ugly head in the form of high oil and food prices, rising labor costs, and a labor market at or close to full employment—it should keep rates relatively high to cool things down.

All simple monetary policy. But what if inflation looms, dictating a rise in interest rates, and at the same time there is an upheaval in the credit markets, dictating a cut? If, say, oil is heading towards \$100 per barrel while at the same time banks find that credit markets have seized up? Being able to solve that dilemma is what gets Bernanke & Co. the

big bucks—or at least virtually unlimited ego-gratifying attention (to add to the lesson, economists call that psychic income).

So far, Bernanke has decided that the risks of creating moral hazard, and of feeding inflation, are outweighed by the necessity of avoiding the externalities associated with a financial panic: He has cut interest rates and pumped liquidity into the financial system. If he needed any sign that he has struck the proper balance, all he has to do is look across the Atlantic to London, where his counterpart, the governor of the Bank of England, came down on the side of avoiding moral hazard. Thereby hangs a sad tale of a central banker who got the balance seriously wrong.



If Ben Bernanke needs any sign that he has struck a proper balance between the moral hazard of inflation and financial panic, all he has to do is look across the Atlantic to London, where the governor of the Bank of England came down on the side of avoiding moral hazard. Thereby hangs a sad tale of a central banker who got the balance wrong.

A major U.K. bank called Northern Rock had a business model built on sand. Its directors had decided that its mortgage lending business would not grow fast enough if it restricted itself to lending only the funds received from its depositors. So it began borrowing in the short-term credit markets, to lend money to potential home-buyers. In bank jargon, it was borrowing short to lend long. For a time this worked: Northern Rock accounted for 20 percent of all net new mortgage lending in the U.K. in the first half of this year. When the credit markets seized up, Northern Rock could no longer borrow enough to meet the demands of its ordinary depositors, even though the mortgages it held were perfectly sound. So it appealed to the Bank of England for help.


It would not have been unusual for Mervyn King, the Bank of England's governor, to respond by lending the besieged bank enough money against good collateral to pay off enough depositors to reassure the others that they need not withdraw their funds. Such an injection of liquidity is the standard practice of most central banks, and is precisely what both the European Central Bank and Bernanke did (to the tune of \$134 billion and \$24 billion, respectively) to try to unfreeze credit markets. But King worried more about moral hazard than did his counterparts in America and on the continent. So he sat on his hands and the Bank of Eng-

land's wallet; depositors panicked, and Britain had its first run on a major bank in over 100 years.

With pictures on front pages around the world of depositors queuing up—in the patient and polite fashion for which Brits are famous—at Northern Rock's offices, the government had to act in order to avoid a great big externality, the collapse of the entire banking system and a severe recession. So it, meaning the taxpayers, guaranteed all of the funds of Northern Rock depositors (there is only limited deposit insurance in Britain). Relieved depositors, many of them pensioners, dropped out of the queue, returned home, made themselves a cup of tea, and calmed down.

This created some risk of moral hazard. But the alternative might have been a cascading failure of illiquid but still solvent banks, with immeasurable consequences for the general economy—including innocent bystanders by the millions. Our old friend, externalities again.

So far, so good. Bernanke injected enough liquidity into the system to avoid cascading externalities, but not so much as to create moral hazard. The axing of Stanley O'Neal at Merrill Lynch, and Charles Prince at Citigroup, should serve as enough of a warning to their successors that a repetition of the failed lending policies of the departed CEOs has career-ending potential. Unless, of course, the new generation of bankers finds the handsome golden goodbyes pocketed by O'Neal and Prince an attractive offset to the ignominy of forced entry into the leisure class.

 Our politicians are not doing quite as deft a balancing act as has Bernanke. As usual, they have been panicked into proposing cures that are likely to do more harm than good. Put the subprime problem into perspective: 35 percent of homeowners have no mortgage debt at all; of those with mortgages, 95 percent are paying on time; 83 percent of those with adjustable-rate subprime mortgages are up-to-date on their payments. Even if this situation deteriorates, and it will, we have to be careful when tinkering with a system that has produced high levels of home ownership and relatively low levels of financial difficulty.

We have to be careful, too, not to underestimate the flexibility of private-sector lenders. Some lenders—not many, so far—are preparing to renegotiate the terms of mortgages, rather than allow the higher, re-set interest rates to trigger foreclosures on the properties of those unable to meet the new payments. A somewhat lower interest rate than had been originally negotiated is preferable to a foreclosed property worth significantly less than the outstanding amount due on the mortgage, and legal fees that come to about 25 percent of the value of a typical subprime loan.

Which brings us to the Treasury, and Hank Paulson. The Treasury secretary is pressing lenders to work out deals with borrowers—“loan modifications and refinancing and other flexibility”—to reduce the default rate. “I don't want to see foreclosures taking place where 50 percent of the people haven't talked to anybody.” Whether lenders, whose self-interest dictates just such a course of action, need prodding is uncertain, although there are some reports that Countrywide, America's biggest mortgage lender, agreed to refinance about \$10 billion in loans and modify the terms of another \$4 billion of mortgages only after the government put pressure on it to do so. It is the lending industry's reluctance to act on a wide scale—for the perfectly good reason that banks don't want to grant relief to those who can meet the new higher borrowing costs—that prompted Sheila Bair, chairman of the Federal Deposit Insurance Corporation (FDIC), to urge the industry to drop its insistence on a case-by-case renegotiation in favor of an industry-wide agreement to freeze the introductory rate on the shakiest mortgages pending individual renegotiation—a step the Treasury is not yet prepared to endorse.

Whatever the outcome, a nudge from the Treasury and the FDIC can't hurt, especially since lenders so far haven't seemed to solve the mechanics of getting these case-by-case negotiations underway on a large scale. The fact that no one seems to know which institution holds which mortgages, many of which are now embedded in securities that have restrictions against renegotiation of mortgage terms, is inhibiting renegotiations. The White House is guessing that lenders can be persuaded (pressured?) to step up their efforts to identify a rather large number of borrowers who “are in the right house with the wrong loan,” to quote one official, and by renegotiating the mortgage terms reduce the foreclosure rate which is, unfortunately from the administration's point of view, due to peak in key, closely contested electoral states (Ohio, Florida, Nevada) in an election year.

Nor can there be any reasonable objection to the decision by most policymakers that it is a good idea to try to reduce information asymmetry. Legislation is in the works to do what can be done to help borrowers better understand the terms of the mortgages to which they affix their signatures. Those documents will remain opaque, however, because of legal requirements that all details be disclosed, and the intrinsic difficulty of explaining the pricing of a service—credit—that is to run for decades.

Besides, the desire for greater symmetry of information between lender and borrower cannot be allowed to morph into a set of rules that will reduce the availability of credit to potential homeowners who can indeed afford to repay their loans. Requirements such as those contained in a bill approved by the House Financial Services Committee—

lenders would have to see to it that borrowers receive “a net tangible benefit” from refinancing their mortgages—will surely scare a lot of capital out of mortgage markets. Consider only the question of the interest rate. It would be the height of symmetry and clarity to bar anything except a fixed rate of interest over the life of a mortgage. But that would deprive borrowers, especially young couples, who can reasonably expect their incomes to rise over the three decades that most mortgages are outstanding, from obtaining low starter rates, with higher re-sets along the way.

All of these issues are involved in determining the extent to which the government should intervene in mortgage markets.

Government, of course, is already a major player through a variety of agencies, especially the so-called GSEs such as Fannie Mae and Freddie Mac (a client of the author’s), whose role is to increase the availability of credit and to lower its cost by buying mortgages from lenders, bundling them, and reselling them to investors. Refuse to allow the GSEs to expand their activities, and you increase the pain in housing markets in parts of the country in which mortgages in the \$417,000 range (Freddie’s and Fannie’s limit) are common, and hit the part of the apartment market that depends on the GSEs for financing. That means forfeiting the externalities that studies show are associated with home ownership, among them safer neighborhoods and better schools, and what Paulson calls “civic involvement.”

Despite Paulson’s jawing, and Bernanke’s support for temporarily increasing the \$417,000 limit on the size of loans eligible for securitization by the GSEs to \$1 million, the White House remains more fearful of moral hazard than of the externalities associated with widespread foreclosures, while Democrats generally prefer a different balance, with moral hazard the lesser of the worries. This difference is merely a subset of the two parties’ views on expanding the role of government, with Democrats more inclined to do just that than the Republicans, among them born-again-fiscal-conservative George W. Bush.

Both parties do seem to agree on the need to reduce information asymmetry wherever possible, with the Democrats generally more willing than their Republican counterparts to risk impeding the flow of capital into the housing market by eliminating the flexibility in mortgage terms that has done so much to make home ownership possible for families that cannot obtain traditional, 30-year, fixed-

interest, relatively high down payment mortgages, but are nevertheless capable of financing a more flexible mortgage.

Balancing all of these considerations on behalf of his colleagues is the congressman from the Fourth Congressional District of Massachusetts, and chairman of the House Financial Services Committee, Barney Frank. The fact that he is playing the lead role for the Democrats is generally recognized even by his political opponents to be a good thing, or at least not a bad thing, considering the alternatives.

Frank is bright, and understands how financial markets work. More important, he is under pressure from two opposing groups, and therefore has to strike a balance. The trial lawyers, an important source of funds for Democratic candidates, would like to festoon the statute books with rules that would, among other things, penalize lenders for making “overly expensive loans.” That would surely make banks find better things to do with their capital than grant mortgages that are an invitation to litigation.

Against the pressure being exerted by the trial lawyers, and probably the anti-banker sentiment of his constituents in the nuclear-free zone of Brookline and the academic community of Wellesley, Frank has to weigh the needs of the traditional upward-

striving, blue-collar Democrats who have benefited mightily from the new, flexible mortgages. They have no desire to see lending shrivel and mortgage rates rise merely to satisfy trial lawyers’ appetite for litigation or the prejudices of liberal upper-income groups, safely ensconced in their homes, financed in large part with traditional mortgages.

Most people on Wall Street have reasonable confidence in Frank’s ability to come up with the right answers, a sort of Bernanke of the legislative world. If men do indeed matter, it might just be that America is well served by the Bernanke, Paulson, Frank troika, as they search for solutions that minimize both externalities and moral hazard, and reduce information asymmetry. Perhaps the injection of liquidity by Bernanke will confine the pain of the current repricing of risk to acceptable levels without creating moral hazard, the flexibility by lenders being pushed by Paulson will minimize externalities, and the legislation being crafted by Frank will reduce the level of information asymmetry. But only “perhaps.” It is, after all, the primary election season, and soon to be an election year, a time when politics trumps economics. ♦

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