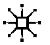
Business Economics
Vol. 44, No. 1
© National Association for Business Economics 

Book Reviews

Subprime Mortgages: America's Latest Boom and Bust

By Edward M. Gramlich, 2007. Urban Institute Press. Pp. 120, $26.50 paperback.

Business Economics (2009) **44,** 57–58. doi:10.1057/be.2008.4

For more than a year, in the United States and abroad, mortgage markets have been in turmoil. Foreclosure rates have risen, Wall Street firms have become distressed, government-sponsored enterprises have required unprecedented support, and the world's banking systems have teetered on the brink of collapse. In *Subprime Mortgages: America's Latest Boom and Bust*, Edward Gramlich explains the origins of the crisis and outlines strategies for avoiding a repetition.

Mortgage markets ought to be well behaved. Residential mortgages are secured by properties whose values are easily estimated. Mortgage borrowers' abilities to pay can be closely approximated, and those borrowers have strong incentives to meet their scheduled payments. Lenders' willingness to issue mortgages is conditioned by the willingness of the purchasers of mortgage-backed securities to assume default risk. The result is that, for many years, credit-worthy borrowers could obtain loans to finance their purchases of appreciating assets (houses) at rates determined in national markets. Foreclosure rates were remarkably low, and when foreclosure occurred, lenders were usually able to recover the full amount they were owed. With such a predictable financing system, about 64 percent of households in the United States were able to own their own homes (Gramlich, p. 3). Less credit-worthy borrowers were relegated to the market for rental housing.

As Gramlich detailed, new lending conventions emerged in the mid-1990s that changed the mortgage market. Several new arrangements facilitated the development of the subprime mortgage market, the market for mortgages for households that do not qualify for traditional loans. The result of that development was a significant increase in the percentage of households that own their dwellings. As Gramlich explained in his fourth chapter, the social benefits of home ownership are significant; and the evolution of subprime mortgages received broad support in Congress and was generally well received in policy circles.

Subprime mortgages carry higher, usually adjustable, interest rates than traditional mortgages. Borrowers may be qualified, not on the basis of household income (and, thus, ability to meet scheduled payments from current income), but on the basis of lenders' abilities to recover the value of their loans in foreclosure (asset-based lending). Some subprime mortgages were issued without supporting documentation on borrowers' credit-worthiness. These loans serve as the underlying assets for complex asset-backed securities, whose risk characteristics are poorly understood.

One of the most troubling aspects of the subprime market is the role of predatory lenders. Although that term is only vaguely defined, Gramlich argued that some originators of subprime mortgages routinely made loans that put economically vulnerable households at substantial risk. It is clear that many of the loan originators in the subprime market, predatory or not, operated with little federal oversight.

With the evolution of subprime mortgages, millions of Americans were able to purchase their own homes. Although these purchases brought social benefits, they left the purchasing households vulnerable. When interest rates rose (and adjustable rate-based monthly payments rose with them), financial stress and increased foreclosure rates were the result. When lenders took possession of homes in foreclosures, only to discover the values of those assets had fallen, the distress spread throughout the financial sector. In recent election campaigns, the result of that distress has been described as "the worst economic crisis since the Great Depression."

Edward Gramlich served on the Federal Reserve's Board of Governors from 1997 through 2005. He was both a recognized

authority on real estate finance and a skillful and engaging author. During his long academic career, he served as professor and chair of the Department of Economics at the University of Michigan and dean of what is now the University's Gerald Ford School of Public Policy. After serving on the Federal Reserve Board, he returned to Ann Arbor as provost, acting as the *de facto* chief executive of the University in the interregnum between presidents. Tragically, Gramlich died in September 2007, just as this volume was appearing, and as the subprime crisis was unfolding.

In this volume, he was at his best in describing the evolution of the subprime mortgage market and the many agencies, initiatives, and regulations that sought to protect consumers in it. Gramlich closed the book with a brief proposal for a thorough reform of housing finance. So many issues and problems led to the subprime crisis that no single policy change would be adequate as a remedy. Thus, Gramlich recommended intervention in the market for rental property, strengthening the consumer protection provisions of the Home Owner Equity Protection Act of 1994, and increasing federal supervision of subprime lenders.

Readers seeking an econometric analysis of the mortgage market will not find it in this volume, although Gramlich's extensive reference list is a guide to that literature. Gramlich could not have known what pain the subprime crisis would generate. Those who do know and who want to understand the history of the subprime market, its social benefits, and what steps could avoid the pain in the future will find this book invaluable.

Opinions expressed are the reviewer's and are not positions of CFA Institute.

Robert A. McLean
CFA Institute, Charlottesville, VA

The Great Inflation and Its Aftermath: The Past and Future of American Affluence

By Robert J. Samuelson, 2008. New York, NY: Random House. Pp. 336, $26.00 hardcover.

Business Economics (2009) **44,** 58–60. doi:10.1057/be.2008.5

Robert J. Samuelson (no relation to Paul Anthony Samuelson of MIT) is an economics columnist for the *Washington Post* and *Newsweek*. His new book is ostensibly about "inflation." But about the time the volume began arriving at bookstores, he penned a column with the title "Deflation is No Longer Unthinkable." It's not easy writing books on economics these days.

Still, all is not lost. With the resurgent interest in Keynesian solutions to our current economic woes, Samuelson's observations may be more relevant than he intended. Despite the title, this book is really about Keynesian economics and the economists who gave Keynesian advice to both Democrat and Republican presidents. It's also about arrogance, hubris, and chutzpah. It's about people whose advice caused great harm and who would have kept on causing harm had policymakers continued to listen.

The background is familiar enough to many readers of this journal. Yet it is a history one is unlikely to find in any introductory economics textbook. Beginning with the administration of John F. Kennedy, a new breed of economists came to Washington, armed with the tools of demand-side management of the economy. They stayed onthrough the administrations of Lyndon Johnson, Richard Nixon, and Jimmy Carter. And the longer they stayed, the worse things got.

By the time Paul Volcker became head of the Federal Reserve System and Ronald Reagan became President, things were bad. In fact, they were very bad. The inflation rate, for example, climbed from barely more than one percent in 1960 to almost 15 percent in early 1980. The prime rate in December 1980 hit a record 21.5 percent. By 1981, 85 percent of the saving and loan associations were unprofitable. The word "stagnation" became part of the American vocabulary.

The cast of characters that wrought these problems is star-studded: Walter Heller, Arthur Okun, and Alice Rivlin, to name a few. Three of them (Paul Samuelson, Robert Solow, and James Tobin) went on to win Nobel Prizes. But as Robert Samuelson is quick to point out, it was the ideas, not the individuals, who were at fault:

> It was the power of ideas that ordained failure, not the shortcomings of

> the individuals. All these Presidents and their advisors embraced the same basic concepts that, despite modest differences and disagreements, inevitably led them to make bad decisions in the name of a good cause.

One such idea was the belief that the economy could be manipulated to eliminate the business cycle. To avert a slump, for example, the government could employ such "pump priming" measures as tax cuts and deficit spending. To avert overheating, the process could be reversed. Another idea was the Phillips Curve, a reliable trade-off between inflation and unemployment. Paul Samuelson and Robert Solow, for example, suggested that an unemployment rate of three percent could be purchased with a permanent inflation rate of 4.5 percent. In defense of such goals, James Tobin wrote as late as 1974 that there was "a vast amount of exaggeration of the cost of inflation."

Yet the theory was wrong, the models were wrong, and the implementation was wrong. Although Samuelson doesn't say so, I find it remarkable that as early as 1962 Milton Friedman wrote in *Capitalism and Freedom* that economists had no reliable theory to "fine-tune" the economy, and as Friedman and Edmund Phelps showed, there is no stable Phillips Curve.

Even though most economists at the time were convinced that the Keynesian model worked fairly well, former Federal Reserve economist Athanasios Orphanides has shown that the errors were huge. At a time when the Federal Reserve believed full employment was between four and 4.5 percent, later estimates put it closer to six percent. Whereas economists expected productivity growth between 2.5 and three percent, for much of the late 1970s, it barely exceeded one percent per year. Whereas the "output gap" in the mid-1970s was thought to be 12 percent, later estimates put it at a modest two percent.

Another problem was politics. Political leaders liked expansionary policies, and the economists apparently were accommodating. The errors of policy were not random. According to Samuelson, they were all in the same (expansionary) direction:

> The Fed's mistakes reflected the powerful political and intellectual imperatives of the time, which reinforced each other. What was politically convenient was also rationalized intellectually.

The upshot is that economists provided the intellectual rationale for disastrous monetary policy. Whereas the money supply grew by 23 percent in the 1950s (mainly accommodating output growth), it grew by 44 percent in the 1960s and by 78 percent in the 1970s.

Aside from the Phillips Curve, the Keynesian economists had no theory of inflation and certainly no coherent plan for dealing with it. Invariably, they saw rising prices as a problem rather than as a symptom of a problem. President Johnson tried to control wage and price hikes by "jawboning." President Nixon imposed wage and price controls briefly. The economic advisors warmed to the idea of an "incomes policy," a euphemism for price controls.

Of course, none of this worked. Samuelson writes:

> Through its history, the Fed has made … only two major blunders. The first was permitting the Great Depression; the second was fostering the Great Inflation … Both stemmed from mistaken ideas.

Enter Reagan and Volcker. Samuelson gives them both credit for a huge economic turnaround and writes that, "If either had been absent, the story would have unfolded differently and … less favorably." To appreciate their accomplishment, consider that six respected economic models at the time implied that unemployment would reach 20 percent if the rate of inflation were brought down to the level actually achieved.

Although actual unemployment peaked at about half that rate, wringing inflationary expectations out of the economy was far from painless. From mid-1981 until late 1982, industrial production dropped 12 percent. In autos, it fell 34 percent. In steel, 56 percent. Yet the exercise worked. The inflation rate fell from 13 to two percent, and a period of unprecedented prosperity followed. The success was a turning point moment. In fact, Samuelson compares it to the Civil War, the Great Depression, and World War II.

For the past 25 years, monetary policy has focused on providing stable prices. Fiscal policy has alternated between goals of budget balancing and supply-side tax cuts. It has been mainly a period of prosperity (creating 46 million jobs), in which pump priming, fine-tuning, the Phillips Curve,

incomes policy, jawboning, and wage and price controls played no part.

Mr. Volker will be heading the Economic Recovery Advisory Board in the upcoming Obama Administration. That's a sign, at least, that the lessons of Samuelson's book might not go unheeded. Business economists will find this book valuable in assessing what might be ahead.

John C. Goodman
National Center for Policy Analysis