Preface

Martin Feldstein

As Ben's remarks indicate, this year's discussion is a very natural follow-on to the themes we discussed here last year. In last year's meeting, we focused on housing, its role in the business cycle, and importantly, its impact on financial institutions. The decline in house prices continues to be central to our economic problems. What started as a subprime issue is now spreading to house and asset classes more generally.

We are in the midst of a financial crisis caused by the correction of a serious mispricing of all risks and by the collapse of house prices that had expanded during a serious bubble. The financial crisis is getting worse because of the downward spiral of house prices.

That decline is being driven by the increasing number of houses with substantial negative equity—that is, with substantial mortgage debt in excess of house values. Negative equity and defaults are such an important problem because mortgages in the United States, unlike most other countries, are generally no-recourse loans. If a homeowner defaults, creditors can take the house, but they cannot take other property or attach income to make up for any unpaid balances. Even in those states of the United States where mortgages are not no-recourse loans, creditors generally do not pursue the assets and incomes of individuals who default.

We can't be sure how much further house prices are going to fall. Experts say that another 15 percent decline is needed to get back to equilibrium level. But there is nothing to stop the decline at that point. As homeowners with large, negative equity default, the foreclosed houses will contribute to the excess supply that drives prices down further. And the lower prices will then lead to more negative equity and, therefore, more defaults and foreclosures. It is simply not clear—at least not clear to me—what will stop this self-reinforcing process.

Declining house prices are key to the financial crisis because mortgage-backed securities and the derivatives associated with them are the primary assets that are weakening financial institutions. Until house prices stabilize, the mortgage-backed securities cannot be valued with any confidence. The uncertain values of mortgage-backed securities, and the associated derivatives, mean that the financial institutions cannot have confidence in the liquidity, or even the solvency of counterparties, or indeed even in the value of their own capital. Without such confidence, credit will not flow, and economic activity is inevitably limited. This shortage of credit is exacerbated by the need of financial institutions to deleverage. And, since raising capital is both difficult and expensive, that deleveraging is happening by lending less.

The macroeconomic weakness in the United States now goes beyond this decreased supply of credit. Falling house prices decrease household wealth and therefore consumer spending. Household wealth has fallen by more than $4 trillion since the peak in house prices two years. Falling employment is reducing wage incomes, and higher prices of food and energy are reducing real incomes further.

The declining economic activity in other parts of the world will also reduce the growth of U.S. exports. The Federal Reserve has, in my judgment, responded appropriately this year by reducing the federal funds interest rate sharply to 2 percent and creating a variety of new credit facilities. The low short-term interest rate helped by making the dollar more competitive. But otherwise, monetary policy is, in my judgment, generally not having the kind of traction that it did traditionally because of the condition of the housing sector and because of the dysfunctional character of credit markets.

So the Congress and the administration responded to this situation earlier this year by enacting the $100 billion tax rebate in an attempt to stimulate consumer spending. Those of us who supported that policy generally knew that past experience and economic theory both implied that such one-time fiscal transfers would have little effect. But we hoped this time might be different. Our support for the fiscal rebates was, in the words of Samuel Johnson, "a triumph of hope over experience."

But our hopes turned out to be frustrated. The data are now in, and the rebates did very little to stimulate spending. More than 80 percent of the rebate dollars were saved or used to pay down debt. Very little was added to consumer spending.

So that is where we are today: in the middle of a financial crisis with the economy sliding into recession, with monetary policy at maximum easing and fiscal transfers impotent.

The agenda of this meeting focuses on what can be done to achieve and to maintain stability. There are two basic questions. First, what should be done to resolve the current crisis—that is, to stop the financial failures and the excess downward spiral of house prices? And, second, what should be done to reduce the risk and the severity of future financial crises?