JACKSON, WYO., – There was consensus among economists, policymakers, academics and central bankers from around the world at the Federal Reserve’s annual Jackson Hole symposium—the topic that they gathered to discuss couldn’t have been more timely: Housing.

The two-day forum is hosted by the Federal Reserve Bank of Kansas City. Wyoming is part of the Tenth Federal Reserve District, which has its headquarters in Kansas City.

Although “Housing, Housing Finance & Monetary Policy” was chosen well in advance of the subprime mortgage crisis this summer, the topic proved quite relevant, said Federal Reserve Chairman Ben Bernanke in his speech, delivered at the opening of the 31st conference during Labor Day weekend.

During the past two decades, many countries have seen remarkable changes in housing markets, including rapid home price appreciation, rising homeownership rates and development of new mortgage finance methods, among others. This year’s symposium explored the causes of these changes and the implications for economic stability and monetary policy.

“Recently the subject of housing finance has preoccupied financial market participants and observers in the United States and around the world,” Bernanke said. “The financial turbulence we have seen has its immediate origins in the problems in the subprime mortgage market, but the effects have been felt in the broader mortgage market and in financial markets more generally, with potential consequences for the performance of the overall economy.”

Two strong themes emerged during the presentations and panel discussions: developments in mortgage finance including the growth of subprime lending, its collapse and the implications; and high housing prices
worldwide, possible causes, and monetary and credit policy implications. Each session concluded with a general discussion period for attendees to ask questions and offer comments to create dialogue.

“Throughout the years,” said Tom Hoenig, president of the Federal Reserve Bank of Kansas City, “the symposium has provided a forum for the exchange of ideas on important public policy issues such as these timely matters. We gather to take the discussion even further.”

Bernanke offered observations about the recent market developments, the economic implications, and the historical context via the evolution of housing markets and housing finance in the United States.

“Obviously if current conditions persist in mortgage markets, the demand for homes could weaken further, with possible implications for the broader economy,” Bernanke said. “We are following these developments closely.”

If credit is more difficult to obtain, consumer spending and investing can be hindered, leading to somewhat slower economic growth. The Federal Reserve also works to ensure stable financial markets, as well as respond to economic weakness from market turmoil.

“The Federal Reserve,” Bernanke says, “stands ready to take additional actions as needed to provide liquidity and promote orderly functioning markets.”

**Subprime mortgages:**
**Before the boom; after the bust**

The onslaught of subprime mortgage foreclosures has been ongoing since late 2006. During the years prior, would-be borrowers who were unable to qualify for traditional mortgages, usually because of weak credit histories, obtained subprime loans. These borrowers paid a higher interest rate than someone with good credit would have been charged. The mortgages often started out with good “teaser” rates, but became unaffordable for some borrowers as teaser rates expired and market interest rates rose.

The U.S. homeownership rate increased from 64 percent to 69 percent during this period—an all-time high with roughly 12 million new homeowners, largely racial and ethnic minorities and lower-income households. Some have been able to pay their mortgages; others have defaulted. Many borrowers said they didn’t understand fully the terms of their loans.

The resulting sharp rise in foreclosures also has caused several major lenders to fold or file for bankruptcy. The impact has been felt worldwide with falling stock prices, especially in mortgage companies, and cast a dark cloud over the already slumping U.S. housing market.

As a response to the subprime mortgage meltdown and to restore confidence to the credit markets, the Federal Reserve Board on
Aug. 17 reduced the primary credit rate at which banks and other depository institutions can borrow money from the Federal Reserve. The goal was to give incentive to borrow from the Federal Reserve and to restore liquidity to the markets. It was a move in line with the Federal Reserve’s role as a lender to financial institutions, and as an authority that ensures sound central banking, Bernanke said.

“The current episode demonstrates that pronounced housing cycles are not a thing of the past,” he said.

Booms and busts play a prominent role in America’s economy—quite notably now in subprime mortgage lending, but historically, too, said Edward Gramlich, a former Federal Reserve governor who wrote a speech for the symposium.

While the details differ, in each cycle there are initial discoveries or breakthroughs, widespread adoption, widespread investment leading to collapsing prices and investors losing money.

“When the dust clears, there is financial carnage,” Gramlich wrote in his speech, adding, “many investors (learn) to be more careful next time, but there are often the fruits of the boom still around to benefit productivity.”

This boom had many causes, Gramlich wrote.

• By 1980, it was no longer illegal for lenders to offer higher-priced mortgages—if the would-be borrower’s credit wasn’t strong, the lender could charge higher interest rates. Mortgage denial rates fell noticeably.
• Automatic underwriting (the loan approval process done by a computer) and securitization (pooling loans and selling the interest to investors) enabled lenders to spread risks more efficiently.
• Nondiscrimination mandates gave banks incentive to offer low- and moderate-income mortgages, which many discovered to be good business.

More than half the subprime mortgage loans were made by independent lenders—
often independent mortgage brokers—without any federal supervision. Although some blamed the Federal Reserve, it did not have oversight authority.

Regardless of whether mortgage lenders are required to sign up for federal supervision or if state agencies begin supervision parallel to federal supervisors, it is most important all lenders play by the same, effective rules, Gramlich wrote.

“If we do not fix the problems,” Gramlich wrote, “we could well get a repetition of the ugly recent experience with subprime mortgages.”

It is now more than just those involved with these risky loans who are affected.

**High housing prices**

During the early 90s, there were no subprime mortgages, but a number of forces were combining at that time to lead to incredible growth in home prices—a dramatic boom that has never before occurred in so many countries at one time, said Robert Shiller, a symposium presenter and Yale University professor. He cited dramatic home price increases not just in the United States, but also Australia, Canada, China, Korea, Russia, the United Kingdom and others.

It’s the role of consumers’ psychology in the housing cycle that is the principal reason for high home prices—high expectations have sent prices soaring, Shiller said. People’s opinions about long-term decisions, such as home buying, change in the short term because their long-term opinions change.

“If there are fears of war or terrorism, as we saw in the case of the 1950 boom, or fears of environmental destruction, as we saw in the case of the farmland boom of the 1970s,” Shiller said, “then there may be major changes in home prices or construction activity even if there is no change in the traditional list of fundamentals.”

Symposium participant Christopher Mayer, a Columbia University professor, said there are other fundamental reasons for high home prices—low long-term interest rates lead to a heightened demand for housing to purchase, which in turn causes home prices to rise, he said.

A fall in home prices would not only affect the housing market, but likely consumer spending, too, said Oxford University Professor John Muellbauer, who concluded liberalized financing affected the housing market and consumer spending.

Historically, low-income consumers didn’t have access to credit. Now, lower-income homeowners are able to more easily borrow against the credit of their homes. This stimulated spending and reduced saving.

However, if the housing market is weak in the foreseeable future because of a tightening of credit since the subprime mortgage fallout, there will be a high number of unsold homes on the market and prices will fall, reducing overall spending.

The availability and cost of housing finance are critical determinants of how well housing markets function, said Susan Wachter, professor at the University of Pennsylvania, and Richard Green, professor at The George Washington University, both symposium presenters. If homeowners only have adjustable-rate mortgages available to them, they have to balance their long-term asset (the house) against short-term liabilities. This can expose homeowners to mortgage payment shocks and could induce economic instability.

Housing is the most important compo-
nent of economic recessions, and an attempt to control the business cycle needs to focus especially on residential investment, said Edward Leamer, professor at the University of California, Los Angeles.

Leamer said at the symposium that the Federal Reserve should pay more attention to real estate because, in the past, declines in home sales and subsequent reduction in new construction has been a precursor to a recession. Symposium attendees were divided on whether the turmoil in the housing market would push the country into recession.

Inflation is persistent and needs to be fought daily, but housing is different—it's the cycle that's persistent, Leamer said. The best time to fight the cycle is on the upswing, not when it has peaked, or the crash down is all the worse.

**Monetary policy, role of the Fed**

Housing turmoil poses a triple threat to the economy with a slowdown in construction, less spending by consumers unable to tap into home equity and now stricter lending standards, said Martin Feldstein, president and CEO of the National Bureau of Economic Research.

While Feldstein suggested the Federal Reserve cut the federal funds rate, which is 5.25 percent, others suggested simply providing liquidity is the best central banks can do.

Federal Reserve Governor Frederic Mishkin said the Federal Reserve’s next step isn't clear. It’s not a central bank’s job to focus on home prices more so than on the effects on overall economic activity. But, central banks should take measures to prepare for sharp reversals in housing prices to minimize the damage to the broader economy. Housing has

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significant ripple effects on employment and inflation—two areas of responsibility for the Federal Reserve.

“...The monetary authorities have the tools to limit the negative effects on the economy from a house-price decline,” Mishkin said.

In his opening remarks, Bernanke said, “It is not the responsibility of the Federal Reserve—nor would it be appropriateto protect lenders and investors from the consequences of their financial decisions. But developments in financial markets can have broad economic effects felt by many outside the markets, and the Federal Reserve must take those effects into account when determining policy.”

What action the Fed should take in regard to the subprime mortgage meltdown also varies. It has been suggested the entire subprime market be shut down (many lenders have stopped offering adjustable rate mortgages) and lending be restricted as it once was in the early ’90s. But, “that seems exactly the wrong message to take from the experience,” Gramlich wrote.

He suggests the simplest solution is to require all mortgage lenders have federal supervision, which would require federal legislation and might cause issues at the state level. It could be difficult to pass relevant legislation. He also suggests involving community groups to a larger extent in order to prevent foreclosures.

“The subprime market, for all its warts, is a promising development, permitting low-income and minority borrowers to participate in credit markets,” Gramlich wrote. “...Our mindset should be to take what is valuable in the subprime boom and build on it, not tear it down.”

Booms and busts play a prominent role in the world economy, and always have done so historically. Such is the case with the subprime mortgage market, and its effects are felt in financial markets worldwide.

Housing, in general, plays an important role in economies. For many people, the home is the largest asset and mortgage debt is the main liability. Home finance makes up a large share of financial market activity in many countries, and is a significant portion of their gross domestic product.

“The interaction of housing, housing finance and economic activity has for years been of central importance for understanding the behavior of the economy,” Bernanke said, “and it will continue to be central to our thinking as we try to anticipate economic and financial developments.”

BY BRYE STEEVES, SENIOR WRITER

1993 Changing Capital Markets: Implications for Monetary Policy
1994 Reducing Unemployment: Current Issues and Policy Options
1995 Budget Deficits and Debt: Issues and Options
1996 Achieving Price Stability
1997 Maintaining Financial Stability in a Global Economy
1998 Income Inequality: Issues and Policy Options
1999 New Challenges for Monetary Policy
2000 Global Economic Integration: Opportunities and Challenges
2001 Economic Policy for the Information Economy
2002 Rethinking Stabilization Policy
2003 Monetary Policy and Uncertainty: Adapting to a Changing Economy
2004 Global Demographic Change: Economic Impacts and Policy Challenges
2005 The Greenspan Era: Lessons for the Future
2006 The New Economic Geography: Effects and Policy Implications
2007 Housing, Housing Finance & Monetary Policy

*After the 1982 symposium, all forums were held in Jackson Hole except the second 1985 event.