Chapter 4
Development of the Housing and Credit Bubbles

I. Introduction

The economic downturn that began in December 2007 was the lengthiest and most severe recession since the Great Depression of the early 1930s. It cost the country more than 8 million jobs and some $2,000 billion of income ($6,500 per person, on average) over the course of 2008 and 2009 alone. Plummeting tax revenues forced states and localities throughout the nation to fire teachers, allow roads and bridges to deteriorate, and eliminate essential services for its most vulnerable citizens. The Great Recession of 2007–2009 and the fiscal measures implemented to combat it pushed the already tenuous federal budget deficit well into the danger zone. A consensus among economists suggests that these costs are likely to diminish only slowly in the coming years. If we hope to prevent a crisis of such magnitude from recurring, it is important to think about the development of the forces that caused this economic disaster.

The proximate cause of the Great Recession was the bursting of the housing and credit bubbles that began to develop during the last years of the twentieth century and inflated rapidly during 2002–2006. The initial decline in home prices after the spring of 2006 acted as an accelerant that set off a conflagration. This fire took down homeowners, financial institutions, and thousands of business firms, including such icons as Merrill Lynch and General Motors. By initiating a vicious cycle of falling home prices, foreclosures of homes on which owners had ceased making mortgage payments, and subsequent liquidation of houses, the crisis spread to the financial system. Commercial banks as well as more highly leveraged investment banks, hedge funds, and other institutions came under severe financial strain. This led to a severe tightening of lending standards, exacerbating the economic downturn.
This chapter discusses the numerous elements that contributed to the formation and growth of dual bubbles in credit and house prices, the inevitable bursting of which led to the broader economic calamity. The most fundamental forces behind the twin bubbles were an irrational and widespread belief that house prices can only increase, along with an increased willingness on the part of lenders to extend credit and borrowers to take on debt. These forces, combined with increasing access to credit and extremely low interest rates, ultimately led to herd behavior that produced the housing bubble by driving the demand for housing—and the associated extraordinary demand for (and supply of) credit.

It is important to note that the causal nexus between rising home prices and increasing credit is bi-directional. Increasing availability of credit on easy terms boosted home buying, driving up house prices. The housing and associated mortgage boom stimulated the introduction by Wall Street and the mortgage industry of financial instruments that boosted the supply of funding for houses and eventually led to a search for borrowers of marginal financial viability. A multitude of financial innovations such as mortgage-backed securities (MBS) and arcane instruments derived from them contributed strongly to the inflation of the credit bubble. Also contributing were the rapid growth of the shadow banking system, a massive inflow of funds from China and other countries exhibiting large trade surpluses vis-à-vis the United States, and extremely low interest rates maintained by the Federal Reserve during 2002–2005.

In addition to these new instruments that artificially inflated home prices, securitization of commercial mortgages, credit card loans, auto loans, student loans, and other items helped fuel a massive expansion of credit used for nonhousing purposes. This helps account for the increase in the share of the nation’s output devoted to consumption goods and services from 67 percent in 1998 to more than 70 percent by 2004.

Of paramount significance was a major increase in risk-taking on the part of financial institutions in the form of acquisition of nontraditional and little-understood financial instruments and in sharply increased leverage. A growing hubris on the part of Wall Street firms developed out of the belief that new financial technologies had made it possible to accurately quantify risk and take measures to alleviate it. These developments coincided with and were abetted by the ascent of increasingly zealous free-market, antiregulatory philosophy in Washington. In the quarter century preceding the crisis, American public policy took an increasingly laissez-faire approach to government regulation and supervision. This trend started with the election of President Ronald Reagan, and continued through both Democratic and Republican administrations, culminating with that of George W. Bush (2001–2009).