The Housing Crisis and Its Implications

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Let's start with President Clinton speaking in the East Room of the White House at a session with his then Secretary of Housing and Urban Development, Henry Cisneros in 1995. One of the great successes of the United States in this century has been the partnership forged by the national government and the private sector to steadily expand the dream of home ownership to all Americans. In 1934, President Roosevelt created the Federal Housing Administration and made home ownership available to millions of Americans who couldn't afford it before that. 51 years ago, just this month, Harry Truman rewarded servicemen and women with the G.I. Bill of Rights, which created the VA home loan guarantee program. That extended the dream of home ownership to a whole new generation of Americans. For four decades after that, in the greatest period of expansion of middle class dreams any country has ever seen anywhere in human history, home ownership expanded as incomes rose, jobs increased, the educational level of the American people improved. But in the 1980s, as the vice president said, that dream began to slip away. I ran for president in large measure because I wanted to restore that dream to grow the middle class, shrink the underclass, promote the mainstream values of work and responsibility, family and community, and reform government in a way that would enhance opportunity and shrink bureaucracy. We made good progress, but we have to do a lot more. I ask all of you just one more time to look at that chart, and I wish I had a lot of other chart to show you that would reinforce that. Home ownership declines then stabilizes at a lower level. At the same time, more and more American families working harder for the same or lower wages every year under new and difficult stresses.

It seems to me that we have a serious, serious unmet obligation to try to reverse these trend. - So there you have President Clinton in 1995 bemoaning the decline in home ownership that has set in over the previous several decades and pledging his administration to increase it. And we will see that Clinton was not alone that the desire to expand home ownership, which is closely associated, as you can tell, from his comments there, with mainstream accounts of the American dream has been bipartisan and pursued by administrations over a number of decades. Our agenda today is to think about what produced the subprime mortgage crisis that played out in the financial crisis that we talked about on Tuesday. Think about the results of the subprime mortgage crisis. And what are the lessons that we should draw, given the larger narrative and concerns in our course. And you really, in order to get an understanding of the housing crisis and how it played, has played itself out, we really have to go back and understand the place of housing in fights about justice and particularly racial justice in America back to the 1930s. And what I'm calling here the transition from hard to soft apartheid, or if you like, from legalistic to market-based apartheid in America, is something that really occurred over the course of a number of decades after the 1930s. If you go back to the 1930s, it would not have been unusual to see signs like this in neighborhoods, particularly, but not exclusively in the south. And this is what I, this is the height of Jim Crow and the era in which explicit racial segregation was the order of the day. When people bought and sold houses, they would often contain so-called restrictive covenants. Here's a passage from a deed transferring some land. It says: None of the said lands, interests therein or improvements thereon shall be sold, resold, conveyed, leased, rented, or in any way used, occupied, or acquired by any person of Negro blood or to any person of the Semitic race, blood, or origin, which racial description shall be deemed to include Armenians, Jews, Hebrews, Persians, or Syrians.

So this is a notion of restrictive covenants and they were, by the way, perfectly legal until 1948, famous Supreme Court decision Shelley versus Kraemer, a five to zero decision with three justices abstaining because they all own houses that had restrictive covenants, and what the court said in that opinion was that while it was a violation of the Equal Protection Clause of the 14th Amendment for states to enforce these restrictive covenants, it was no violation of the Constitution for people to put them in the deeds of houses and voluntary abide by them. So if you were, wanted to signal to buyers that this is a Whites only neighborhood and we shouldn't allow non-White to come in, that was not illegal. And so, and that of course goes back to something I mentioned to you in an earlier lecture, namely after Reconstruction, we had very restrictive readings of the civil right, Civil War Amendments by the Supreme Court and in particular they said of the 14th Amendment that it didn't apply to private action but only state action. So Shelley versus Kraemer in 1948 said these restrictive covenants could no longer be enforced, but that didn't mean that they went away and they didn't for some time thereafter. This is something called the 8 Mile Wall in Detroit. Anyone here from Detroit? Anyone know what the 8 Mile Wall was? It was actually half a mile long, it's not eight miles long, it's half a mile long, but it's on something called 8 Mile Road, and 8 Mile Road was a physical barrier between White and non-White neighborhoods. So the idea was to keep African American, presumably principally African American children from going into White neighborhoods and it since, you can see, has had been covered in graffiti, but it's still there as a kind of monument to the physical segregation, what I'm calling hard apartheid of the Jim Crow era.

That was actually, the 8 Mile Wall was built in 1941. Anyone know what this is? It's a map, yeah, what's all the scribbling on it? - Redlining. - This is so-called redlining, and you can see this saying, this is an OK place to write mortgages, this is OK, this is super, this is the hood, and this is don't even think about writing mortgages in this neighborhood. And so actually the history of redlining goes all the way back to the 1930s and initially the government was in fact behind it. In 1934, we got the National Housing Act which created the Federal Housing Administration, and the following year, they commissioned the Federal Loan Bank Board to run studies in 239 cities in the service of underwriting. They wanted to help underwriters know where these risky loans actually were. And so the idea was that mortgage underwriters would know what to charge and whether, and what circumstances underwriting would be warranted. But of course, it soon became a proxy for denying loans, mortgages in minority neighborhoods and to minority lenders. So redlining became used for that purpose. And as you can see, just if you Google up redlining on Google Images, you can find maps of virtually any American, and by the way, also Canadian cities from this period. This is one from Seattle, and you can see there from the color code, the green is best, the blue is still desirable, the yellow is the declining neighborhoods, and the red, hence redlining, was hazardous. And so that's one from Seattle, I've just put a few up here, one from San Francisco, Buffalo, New York, Austin, Texas, and I could've put many, many more, many more of these. And so this practice of redlining reinforced, of course, racial and class-based segregation of neighborhoods, because banks would only want to lend in the areas that were least risky and most desirable. In 1968, the Fair Housing Act prohibited discrimination in lending based on race and also by neighborhood.

This was reinforced by even more stringent legislation a decade later, the 1977 Community Re-investment Act, reiterated these bans, but they're extremely difficult to actually enforce. This is what I'm calling the era of soft apartheid, you don't necessarily need restrictive covenants and we'll see this play out in four-part harmony and in the rest of today's lecture. But even though redlining and loans based on discrimination either against particular neighborhoods or by race has been illegal since the 1960s, as recently as 2015, there were huge settlements with banks who had been caught in this practice. For instance, Hudson City Savings Bank, which services New York, New Jersey, and Pennsylvania reached the largest settlement ever with the Department of Justice, $33 million settlement for denying loans to African American and Latino borrowers and were required as part of that settlement to open branches in minority neighborhoods. And in that same year, there was actually a $200 million settlement with HUD, the Department of Housing and Urban Development, between, for a bank called Associated Bank for doing the same thing in Chicago and Milwaukee. And again, they were required to open branches. So even though redlining is no longer legal, that doesn't mean it doesn't occur. And so this is one of the ways in which it's become possible for markets and market practices essentially to underwrite the segregation of neighborhoods. So I asked you to spend a little bit of time with the Parable of the Polygons, the Schelling, which is a user-friendly version of Schelling neighborhood tipping game. Who did, did you spend some time with it? What did you take away from it? - I found it a little depressing when I got toward the end. - What's depressing about it? - Well, that in most of the scenarios, you end up with very segregated neighborhoods and you have - But how do we get to segregated neighborhood? - Well, there was, a lot of the rules were about, you're only happy if, they came down with the 1/3 rule, so if it went down - Just back up a little bit and explain how it works for anybody who didn't - All right, so there's two types of polygons.

There's the triangles and the squares. And basically the point of the game was to show you at what point, by looking at the map, when all the triangles and all the polygons were happy based on who their neighbors were. And what you discovered was that the more you played around with it, you needed to have segregated neighborhoods for people to be happy or generally happy with their environment. - Okay, anyone want to add a point that was taken away to what he said? Yeah? - Yeah, I was just really surprised by how little personal bias it takes in order to get - Okay, sorry, elaborate on that. - Collective bias. Because even though one square or triangle might only need to be surrounded by like 1/3 of people who are like them to be happy, the way that that ends up playing out is that in order for everyone to be happy it reconfigures so that you're actually really surrounded by people who are mostly like you. It doesn't actually factor out to that 1/3 in like a collective way. - Exactly, so he's, just to summarize what you're saying, very mild levels of prejudice, where mild is understood to mean, I just want some of my neighbors to be like me, 20% to 1/3 is enough to, of course, entire neighborhoods to segregate completely. So very low levels of prejudice will segregate neighborhoods simply by the voluntary choices that people make. You don't need restrictive covenants, you don't need all this other stuff to get it, that's what I'm calling soft apartheid. And not only that, it's very difficult to undo, it's very difficult to reverse, and less people have an active desire to integrate. That we have to change their preferences, otherwise, with very low levels of discomfort at having large numbers of your neighbors be unlike you is gonna be enough to segregate neighborhoods. And so this is a very famous, Schelling was a brilliant economist, most of his works is on arms races, but this neighborhood tipping game tells you that if you start off with a neighborhood that looks like that and people have these very low levels of desire to be surrounded by some people like themselves, it's gonna wind up in pretty short order like that.

And of course, we don't start off with something like that in most American cities, so it's even tougher. What we really start off is something much more like this, this is a map of Chicago with neighborhoods are already heavily segregated. And what would be required would be to desegregate them and that's taking Schelling to heart is not going to happen unless you have pretty radical changes in the population. And so in some ways, it might be said that actually soft apartheid is harder to combat than hard apartheid or Jim Crow. I've given you one reason already, first of all, you would really have to have active changes in people's preferences, positive desires to desegregate the neighborhoods, not just absence of resistance to the desires of others. Any other reasons why soft apartheid might actually be harder to fight against than hard apartheid? By hard apartheid, I'm talking about de jure, restrictive covenants, laws outlawing people living in certain neighborhoods and so on. Yeah? - Is it more unconscious, like unconscious bias? - It could be, there could be issues of unconscious bias, that might be part of it. Anything else, what were you gonna, yeah? - There's an economic factor now, housing prices have gone so much that it's difficult to actually, even though you enforce it, to have people move in if they have lower incomes. - So people are gonna self-segregate by socioeconomic status, yep, okay. Anything else? - It's much harder to prove. - Pardon? - It's much harder to prove. - It's harder to prove, and it's harder to identify. If you think about hard apartheid, it provides targets. If you wanna get rid of restrictive covenants, let's say, we can have a campaign to get rid of restrictive covenants, gives you a kind of a proximate goal to organize around and to get rid of and I'm gonna come back more and talk about the importance of proximate goals.

There's also a literature in psychology about so-called boundary permeability. Academics never say in words of one syllable what can be said in words of five syllables. But here, this is the basic idea. If there's a law which says no Blacks and Jews can join a New Haven Lawn Club, there will be a campaign to get rid of that rule. There will be a campaign to have Blacks and Jews allowed to join the New Haven Lawn Club. If there's no rule, but one Black family and one Jewish family is allowed to join every 15 years, there won't be a campaign. Similarly, if you have a rule which says no junior faculty will get tenure. Then you'll get a junior faculty union. If you don't have a rule, but in fact, only one in eight of the junior faculty gets tenure, which has been a Yale equilibrium for many decades, then you don't get a junior faculty union, why? It's not entirely clear, but it may well be, and this is claim in the boundary permeability literature, everybody thinks I'm gonna be the one, I'm gonna be the one, so if you have norms or practices that function so as to produce exclusion without actually having formal exclusion, it becomes much more difficult to get people to organize, to change them. And so this is, if you look at something like the Civil Rights Act, and you say this is 1964 and the Voting Rights Act of 1965, what has been, what's been achieved? It's mostly that the de jure, rather that the de facto forms of racial discrimination that have been stamped out. It's much harder to stamped out the de facto. So we have inherited a world in which the hard apartheid of the Jim Crow era has been replaced by the much more nebulous, but in some ways, more difficult to deal with, soft apartheid, that gets generated as a byproduct of the lack of proximate goals, the tipping phenomenon that Schelling describes, and the very big obstacles to organizing collective action in circumstances where you have high levels of boundary permeability.

So that's something to bear in mind and we'll come back as we see how this played out. People attempting to combat the effects of soft apartheid played out in the housing crisis. Now, if you said, what was the cause of the housing crisis, there's no single answer, it was really a perfect storm. A number of factors came together to produce this result. And I wanna mention four. The first one we've already heard from President Clinton's mouth, and here I, this he wrote the year before that speech, but here you can see, "More Americans "should own their own homes, "for reasons that are economic and tangible, "and reasons that are emotional and intangible, "but go to the heart of what it means to harbor, "to nourish, and to expand the American dream." Home ownership is part of what people who want to realize the American dream aspire to, and a big part of the housing crisis grew out of the agenda of extending home ownership to previously excluded racial and ethnic minorities, exactly the people who are being discriminated against as a result of soft apartheid. And this graph sort of reflects the numbers that Clinton was talking about, you can see that in March of the, starting actually at the beginning of the post-war period, you see big increases in home ownership, and then it levels off and successive administrations do take actions to increase it. Now we're gonna talk about till it finally reaches a peak in 2008. Second is securitization of the subprime mortgage market. So just to be clear, a subprime mortgage is, we're talking about the subprime mortgage crisis, what is a subprime mortgage? A subprime mortgage is a mortgage that is risky to hold. It is risky because it is being given to somebody who either has not a very good credit history or it's being given with a very low down payment so that the home owner doesn't have a lot of incentive to keep paying the mortgage, we're looking at more about that later.

It's a mortgage that it's risky for a lender to hold. It's subprime and so normally, in a market system, subprime mortgages charge higher interest rates than regular mortgages precisely because they have to bear the cost of that risk. So that's what a subprime mortgage is. Now, securitization of subprime mortgages, what securitization of subprime mortgages refers to is the following, if I had wanted to buy a house, say, in the 1970s, I would have gone down to the local bank, they would've said, "You want a mortgage? "Well, give us your credit history," I would've had an interview with the bank manager and I would have had to put 20% down on the house, the bank would have, probably the bank manager would have known me, it would have been, I lived in Guilford, that would be in the Guilford Savings Bank as it in fact was, but they would run their credit history, they would become comfortable with lending me the money, I would take out a 30-year mortgage and they would then hold that mortgage and service that mortgage and I would spend the next several decades paying off that mortgage back to the Guilford Savings Bank, that is basically how mortgages used to work. Securitization is the process whereby banks not only sell, once they give the mortgage, they sell it to another bank or another financial entity and those mortgages then become chopped up and sold off in pieces and traded. So they start, they become securities. And it's important to understand that the securitization of mortgages actually begins with the federal government. Fannie Mae, Fannie Mae is so-called government sponsored entity. It was established in basically the 1938 as part of the second new deal in the wake of the depression, more than 25% of America's home owners had their homes foreclosed on in the depression, and it was extremely difficult for people to get mortgages, to buy homes.

And so the Roosevelt administration wanted to make it easier. And so what the Freddie, Fannie Mae quickly got involved in doing was essentially two things. One was buying up mortgages from banks, and secondly, creating liquidity, because if you think about, if Guilford Savings Bank is holding that mortgage for 30 years, they can't use that, they can't give another mortgage with that same money, but if they sell that mortgage to Fannie Mae, they can then use the money to give out more mortgages. So Fannie, starting way back in the 30s, but much more in recent decades began buying up mortgages to create liquidity in the mortgage market. And then they also wanted more money with which to do this. So they began the process of securitization. Fannie Mae actually started chopping these mortgages up and selling them and then they would become traded as securities. And it's, it was a government entity, but eventually it became partially privatized. So you can trade Fannie Mae stocks on the stock exchange now, it's a public-private partnership, if you like, and that is part of the source of its problems. But the securitization of mortgages essentially got going because Fannie started selling them off and then they would be resold and repackaged and resold and repackaged, and more and more finely sliced. And they got the great book about this is "The Big Short" which some of you might have read, but people had very little understanding about internal composition of these buckets of mortgages that were being traded. Another thing that nobody was aware of at the time but became obvious in hindsight was people had generally thought of real estate as a hedge against the stock market, because you don't wanna have all your eggs in one basket. But the more you had the securitization and trading of these mortgages on Wall Street, the more actually they were operating in tandem, and so when the real estate markets crashed, so did the stock market.

The government started to do this, but then private banks also started to do this, and the big investment banks got into their own securitization and indeed after 2002, 2003, 2004, when regulators were finally getting nervous and started pulling back the government's activity in securitization, that's when the private sector securitization ramped up. And so the good news was that more and more liquidity was being created, it was getting easier and easier to write these mortgages, the bad news was that there was more and more vulnerability in the system and people started to lose the incentive to conduct the sort of due diligence that you would otherwise conduct in giving out a loan. If the Guilford Savings Bank is gonna give me a loan, they need to be confident that I'm gonna be able to pay that loan back. If the Guilford Savings Bank is gonna sell the loan they give me to somebody else the next day, then it doesn't matter to them whether two years from now I'm not gonna be able to pay my mortgage. So they don't have the same incentive to do the due diligence in giving out the loans. And it's not just in giving out the loans. If you think about appraisals, if the Guilford Savings Bank is giving me a loan, they wanna be sure that when they're told the house is worth $150,000, it is worth $150,000. If they're gonna sell that loan, it doesn't really matter, and so you started to get not only the phenomenon of drive-by appraisals, but what the appraisal company soon discovered was that if they didn't give the appraisal, that the borrower and lender wanted in order to facilitate the transaction, they would just go to another appraisal company. And so the appraisal company's also were complicit, and indeed, I can remember refinancing a mortgage in about 2006, 2007, I wanted to borrow out the equity to do this and that, and I needed the appraisal to be some number, I've forgotten what it was, $850,000, and we got the drive-by appraisal, it said it was worth $900,000, and I remember sitting there in signing the papers looking around the room, the guy from the bank, from the attorney, and so on, I thought, nobody in this room believes this house is worth $850,000.

And indeed, it turned out later it was not. But there it was, nobody had the incentive to do the kind of due diligence. So the securitization of subprime mortgages is, and we'll see why we got more and more subprime mortgages in a minute, but there were a lot of these very high risk mortgages that were being securitized and being traded and there was nobody with enough so-called skin in the game to have the incentive to do their own due diligence. The third component of the crisis was what we talked about last time, the behavior of the banks, the relentless drive to deregulate them and make it easier for investment banks in particular to get involved in this activity. But the fourth and most important in many ways piece that I wanna emphasize was politics. And so the idea that the government should get involved in addressing soft apartheid goes back at least to the 1980s. This is Jack Kemp, quarterback for the Buffalo Bills. He was actually in 1996, Bob Dole's running mate in his failed attempt to unseat President Clinton, but before that, sorry, after that, before that, 1989, he was Secretary of Housing and Human Development in the George Herbert Walker

Bush administration and he called himself a bleeding heart conservative, and he came up with this idea of HOPE programs, Home Ownership for People Everywhere is what HOPE stood for, Home Ownership for People Everywhere. And he had this idea that the government should sell off, this was like Margaret Thatcher's privatization of council houses in London. The government should sell off all its public housing to the owners and he was beating the drum to do this, he actually ran into huge opposition within the Bush administration from people like Darman who's managing the budget, and Congress was not very excited about funding it and it turned out that just to get one of these government owned houses sold was gonna cost close to $100,000, so it kind of crashed and burn but it didn't really work as a policy.

But Bush did it about whether to get behind it, then we have already seen that in the Clinton administration, there was a lot of effort to get behind this. And it didn't just come from Clinton, it came from the left of the Democratic Party and from minorities in the Democratic Party. This is Barney Frank, as in Dodd-Frank Frank. He was considered a very liberal congressman and he was a huge champion for saying to Fannie Mae that you have to put pressure on these private loan originators to give mortgages to low income neighborhoods, to minority neighborhoods. Maxine Waters, congresswoman from California was part of this same group of people, and so essentially, what happened was that Congress started putting pressure on Fannie and Freddie Mac, which is a, Freddie Mac is a younger and smaller Fannie Mae created in 1970 to have some competition in this market, but essentially, Congress, under pressure from these kinds of people in Congress was saying that you have only to make, you have only to make Fannie Mae funds available in subprime mortgage markets. That is what bankers would call subprime mortgage markets in minority neighborhoods, in poorer neighborhoods, and then came relentless pressure to make the subprime more and more sub, so reducing down payments from 20% to 10% to 5%, eventually to next to nothing. And again, using non-traditional criteria for granting people mortgages in terms of evaluations of their credit and so on. And when people say, oh, so it's actually the government that caused the financial crisis, which conservative sometimes argue, this is what they're talking about. Because they're essentially saying that these practices by Fannie and Freddie distorted the whole mortgage market because they, after all, even though they are publicly traded, are underwritten by the taxpayer.

So they can take more risk than they would if they were not underwritten by the taxpayer. But that means that private sector lenders have to do the same thing if they're gonna be competitive. So the argument gets made that these practices distorted the entire mortgage market and create and even as the government started to get out of the business of securitizing subprime mortgages in the new millennium, nonetheless, they had already created this world in which the only way in which lenders could compete was by giving more and more risky loans and further because of the process of securitization, everybody underprice the risk because everybody was passing them on. It's one of the reasons I think Alan Blinder called his book that I was referring to last time "After the Music Stopped," you don't find out who doesn't have a chair to sit on until the music actually stops. And so that is what they, that became the game. And there was enormous pressure in the Clinton administration and it continued into the George W. Bush administration as well. Again, pressure to reduce underwriting standards and so on. And it was heralded just as Clinton had heralded it and Bush had also heralded it as expanding the American dream into minority communities and making home ownership available on a more equitable basis. So let's talk about the aftermath when it all came crashing down for a minute. And I wanna have you listen to a colleague of mine in economics department for a few minutes by the name of John Geanakoplos. He is one of the most brilliant people at Yale. He's one of those people, if he's giving a paper, you just go. You know you'll learn something. He also happens to, he happens to have a hedge fund that invests in mortgage backed securities, so he knows whereof he speaks, and this is his post-mortem on the subprime mortgage crisis. - Some errors. So what we did right, I guess, is we averted a complete collapse of the banking sector, but that is also the source of what we did wrong, because we were so obsessed with the banks that we forgot what caused the crisis, which was the subprime mortgage market and the mortgage market in general, home owners and what would happen to home owners.

So we've lost about four million or five million households to the crisis who've been thrown out of their houses, and another couple million more that are on the way out that still haven't finished with the foreclosure process. So altogether, they're gonna be something like six million or more, maybe even will get to seven million households that will have lost their houses. If you're thinking three people per household, maybe some people had multiple houses, so it might be a slight exaggeration, but we're talking about 20 million people lost their homes and who would've thought that America would ever have to deal with 20 million people losing their homes? And who would have had to deal with this long period of stagnation and growth, which I think is related to the housing crisis. So I think the biggest mistake we made was concentrating too much on the banks and recapitalizing the banks both during the crisis and still now and too little on helping the home owners, who I think were the heart of the crisis. So to give you an example, we have a lot of data now on what happen to people who lost their homes and what happen to the lenders. So a typical subprime loan might have been for say $160,000 and the house originally was worth a little more than $160,000. But during the crisis, housing prices fell quite dramatically and that kind of house conceivably could have fallen to $100,000. So think of yourself as a subprime borrower with a bad credit rating to begin with, that's why he is or she is a subprime borrower, who owes 160,000 on a house that's only worth 100,000 in a time period where the future looks very bleak for earning money, for example. It would be almost crazy for such a person to keep paying. And in fact, most of the people didn't continue paying for a while in 2008 and 2009.

Six or, people now position six or 7% a month, not a year, six or 7% a month were defaulting on their mortgages. So every month, there'd be a new and different set of 6% or so who defaulted on their mortgages. So what we did in most cases was tell them they'd stop paying. The Obama administration might have lept in and said, "Oh, it must be because you don't have a job, "we'll try to reduce your interest "payments for a little while." But so, imagine again you're that person who still owes 160,000, instead of paying 8% a month, you now pay 4% a month. Your house is still worth only 100,000. So what happened was 50 to 80% of those people after about a year re-defaulted. So the plan of helping the homeowners by reducing their interest payments for a while till they got over the bad times was completely unsuccessful. They defaulted. And what happened to the lenders after the default? The homeowner didn't just walk away from his house, he sat there until he was thrown out, which took on average almost three years, during which time the homeowner didn't pay his mortgage, after he found he was gonna lose his house, he didn't pay his mortgage, he didn't pay his taxes, he didn't fix the house, and on the way out of the house, maybe some things got taken or the house got ruined on the way out. So we have the data now, the recovery in such a situation was in fact, on all the subprime loans was under 25%. So the lender would've gotten back 40,000 out of the 160. Had we forgiven some of the debt, had the lenders gotten together and reduce the debt from 160 to 90 and maybe even slightly subtle, more subtly said, "We'll reduce your debt to 90, "but in case the house goes back up in price, "we'll raise the debt, 50% of the increase in the house "we'll add to the debt again." Had they done that, they probably would've gotten their 90 because the home owner now could've seen that his house was worth more than the debt. At worse, the home owner could've sold the house and pay back the 90 and kept 10.

And so the home owner would've been better off, the lenders would've been better off, because they would've gotten 90 instead of 40, and the economy would've been immeasurably better off, and by the way, the banks, would've been better off, because that's where they were losing all their money in those kinds of loans. So I think our biggest mistake was that we focused on the banking sector and trying to recapitalize it and find enough money for the banks, and we didn't focus on the home owners whose debts were actually owned by the banks and who were gonna determine the fate of the banks at the end anyway. And we would've done much better concentrating on the home owners. I think that is the major mistake, major policy blunder that the Obama administration made. And they made it not because it never occurred to them, because people like me, and I wasn't alone, went and talk to them and said, "This is what you should do." I even testified in Congress a few times. And it's not just academics like me who were saying things like that, it was the business people who were making the investments and who effectively owned the loans who also wanted to see the debt forgiven. This isn't some pie in the sky, academic idea, there were a number of hedge funds, these mortgages, they're not done individually. A bank may give the mortgage, but the banks then sells the mortgage into a pool, and it's the shareholders of the pool who are effectively lending the money, the bank is just the middle man. So a bunch of, but these bondholders, shareholders of the pools, they don't know each other, so it's very difficult for them to coordinate any activity. That's why we need the government to coordinate things that are difficult to coordinate otherwise. So a bunch of those hedge funds and other investors also testified in Congress that they would like to see the debt forgiven not because they were good guys but because it would help them as well as helping the economy.

And we just weren't willing to be bold enough to listen to those voices and we didn't take, I think, the most important step we could have to make the ensuing recession less dramatic. - So why didn't the politicians take Geanakoplos's advice? He's saying it would've been an all around win. The banks, the home owners, the investors would all have been better off. Why didn't the government do that? Any, any thoughts about why? Yeah? - I just feel that everyone thought that they had a good thing going at that point, and they didn't want to put a monkey wrench in there. - Well, but this is when we were having mortgages defaulting at a very alarming rate. So that can't be the story. Any, yeah? - For me, this is akin to getting away with murder. So if you know that you can taken a loan and they'll cut it to half, then why pay the loan at all, 'cause you know you can get away with it. - So you're worried about the moral hazard problem. Well, let's hear elaboration of the moral hazard problem here. - I tell you what, I have an idea. The new administration's big on computers and technology, how about this, President, new administration, why don't you put up a website to have people vote on the internet as a referendum to see if we really wanna subsidize the loser's mortgages or would we like to at least buy cars and buy houses in foreclosure and give 'em to people that might have a chance to actually prosper down the road and reward people that could carry the water instead of drink the water. - Hey Rick, it's a novel idea. - Hey, Rick They're like putty in your hands. Did you hear - No, they're not, Joe. They're not like putty in our hands. This is America, how many of you people wanna pay for your neighbor's mortgage that has an extra bathroom and can't pay their bills, raise their hand, hello, we all. President Obama, are you listening? - How about we all stop paying our mortgage? It's a moral hazard. - Hey, Rick, how about the notion that Will reported that you can go down to 2% on the mortgage - You could go down to minus 2%, they can't afford the house.

- And still have 40% not be able to do it, so why are they in the house? Why are we trying to keep 'em in the house? - I know Mr. Summers is a great economist, but boy, I love the answer to that one. - Jason, Jason - You're thinking of having a Chicago Tea Party in July, all you capitalists that wanna show up at the Lake Michigan, I'm gonna start organizing. - What are you jumping - So that is so-called Rick Santelli's rant. He is a financial commentator, that was a morning on the Chicago Mercantile Exchange in February of 2009, the Obama administration had just taken office and it's a famous rant because you've heard him calling for a tea party in July and that is often credited with galvanizing what became the Tea Party movement, Rick Santelli's rant. Although some people dispute and say his influence has been exaggerated, but it's become emblematic of the scorched earth resistance to doing anything remotely like that. And so one argument he's making there is the moral hazard argument. Now, people like Geanakoplos and others, they weren't entirely ignorant of such things, and there were ways to address it, namely first of all, to point out to people that if you didn't write down these loans, say of your neighbor's home, your house has become even worse, even, it's gonna lose value, because it's gonna be next to a decrepit house. And secondly, the people who did get mortgage assistance, for example, what the government, as John Geanakoplos said, they would give them a lower interest rate for a while, it didn't work because of the underlying incentives didn't line up, but they were put through humiliating hell. It wasn't like you just filled out a form and said, now I get my mortgage reduced, or my interest rate reduced, you went through endless interviews with people that made you prove your need, this is like the sorts of humiliating things people have to go through to get out of government assistance.

So the argument was that there are ways to manage the moral hazard, if you like, even if you can't make it entirely go away. But the Rick Santelli's rant, I think is instructive for other reasons, which is, go back to, remember our discussion of the Capuchin monkeys when I said that the researcher misinterpreted the result of his experiment when he said that the angry monkey was like a Wall Street protester, and it's really people make much more local comparisons, and it's the idea even if you're gonna be worse off because your house is gonna get less valuable being next to a dilapidated house, you make the local comparison and that becomes the source of your resentment. And so for this reason, the kind of proposal that Geanakoplos and others were pushing is dead on arrival. Even though people are gonna have to actually take an absolute hit for refusing this kind of assistance, it's not gonna possible to mobilize them behind that. And it might not surprise you to know that, you maybe can guess from his name that John Geanakoplos has over the last number of years be in acting for the Greek government in its dealings with the IMF and the European banks where he's made exactly the same argument. He said the Greeks cannot pay their debts and you should write the principal down because all we're doing by, they just keep rescheduling it into the future, they're not solving the problem. What they should be doing is saying for every euro you pay, we will forgive the principal you owe by two euros, or something like that. And it won't surprise you to know that he's got no further defending the Greek government than he got defending the home owners during the mortgage crisis. And that is because brilliant economist as he is, he's not paying enough attention to the politics of the situation and the resentment that would get generated if the government did do this on a significant scale. So even though it makes pristine economic sense and Geanakoplos is right that everybody would have been better off, it was something that was politically was dead on arrival.

And that's scarcely surprising. It should also just be said that the banks were divided about this. They were not as united as that clip suggests. Some of them actually preferred the wholesale buyouts, bailouts of the banks rather than worrying about the home owners, partly because there would've been quite substantial transaction cost to doing it they would have had, because the mortgages are owned by many people and so how you're actually coordinate the writing down. At the end of the day, the really simple way to do it would be even harder politically, which namely the government would've just given the money to the home owners, written them a check, but again, I think, for reasons we're gonna go into next week, for government to give people checks is politically very difficult. There's also, was also some sunk cost fallacy, so this is related to loss aversion that I've talked to you about, which is if a lender writes down a debt, you're admitting you made a bad loan. Whereas if you hope against hope that the market's gonna come back, you will not have to own the fact that you made a bad loan. So you see this all the time, an economist will tell you if you're trying to decide whether or not to sell a stock, the only important question is what is it gonna be worth in the future if I don't sell it today. But nine of 10 people will focus on what did I pay for this stock. It's the wrong question. For an economist, it's a completely irrelevant question what I paid for the stock, but Kahneman inference, a psychologist who understands the human psychic cost of internalizing the fact that you've lost something means that you will irrationally ignore the data that you should be paying attention to, which is not what did I pay for it, but whether, what, if I don't sell it today, what will I be able to sell it for tomorrow.

So it wasn't only the issue that Geanakoplos was speaking about, but certainly, that was a significant part of it. So what do we to make of all of this. So here, we've had this long history, as I said, the transition from hard to soft apartheid did not get rid of class-based and race-based discrimination in housing markets, it just made it more difficult to deal with. Here we had decades where success of administrations, Democratic, Republican, Democratic, Republican, sought to address this problem by first outlawing discrimination based on neighborhood and discrimination in who you would give mortgages to. This created all this pressure on Fannie Mae from the federal government to restructure mortgage markets to make them more friendly to minorities, but when we look at how this all played out, it's not a happy story, if you look here, the run up to the financial crisis here, you can see that African Americans and Hispanics received a great majority of the increase in subprime mortgages. And if you look into the aftermath of the crisis, when everything came crashing down, Blacks were 47% more likely to be facing foreclosure than Whites, Latinos were 45% more likely to be facing foreclosure. If you look at the loss of property, you see from 2007 to nine, nearly 8% of both African Americans and Latinos lost their homes to foreclosures, basically double the rate of Whites. African Americans were 80% more likely to lose their homes compared to similarly situated Whites and Latinos was 70% more, and if you look, more likely. And if you look at the recovery after the, that I ended with last time, you can see again that this is household wealth. By 2009, it was starting already to turn around for Whites but not so for African Americans. If you look at changes in home equity, you can see that in the run-up to the crisis, Whites represented there by the blue bar, their increase in equity slowed relative to Blacks, but in the crash, the Whites lost less and turned around more quickly, turned around more quickly than it did for African Americans.

So not entirely a straightforward story. In fact, in 2016, right at the end of the Obama administration, they did start doing a little bit of what Geanakoplos had been advocating. Fannie and Freddie approved a one-time plan to reduce mortgage balances with unpaid principal balances of 250,000 or less, but 33,000 home owners were expected to qualify, many fewer than that actually took advantage of it. They also, in their settlements with banks, the government gave the banks some incentives to write down principal. In 2013, they gave JP Morgan Chase $1.15 credit towards its huge settlement for every dollar of loan forgiveness that they offered home owners. So they did, and they did a similar thing with Goldman. So they did do a little bit of this at the margin, but nothing on the scale that would have made a dent in the problem. And if you look at projections of the effect that this has had on the creation of wealth into the future, you can again see that this big wallop that African Americans have taken during the collapse is gonna cost them and their children for many decades into the future, I'm not sure projections this far out worth that much and so I wouldn't put too much stock by the absolute numbers, but the general trend is clear. If you look, this is the peak to the trough. You can see African Americans and Hispanics lost more value in their homes, and then the trough to the peak, they gained back less. And we see, if you look at home ownership rights by race, you can see that African Americans, again, the pink line on that graph have fallen to levels that hadn't existed for many decades. And this has produced a new rounds of outrage in people, you could be saying, here we go again.

These are some headlines from newspapers last year complaining that Black home ownership is as low as it was when housing discrimination was legal and Black home ownership rates are where they were 50 years ago.

The Urban Institute, a liberal think tank says, "We've made important progress, "but we can't claim to have vanished housing discrimination "and its pernicious effects." And so here we are again, we are starting to see pressure to make home ownership available to less advantaged groups. Now you might say, well why is home ownership so important, why is it centrally associated with the American dream? And anyone wanna take a shot at that? Why do we, why do people care about home ownership so much? Why is it important that people own a home? - Financial security. - Financial security is one answer. We'll see how much financial security it really gives them. - It's a major avenue for wealth creation. - Pardon? - Wealth creation. - Okay, so let's start with that. People think that home, it's a way of creating wealth because most people believe that the value of homes always goes up. People believe that, that's one reason, but Shiller's book "Irrational Exuberance", this is Robert Shiller, our colleague in the Economic Department, a Nobel Prize winner, he wrote a book, this book "Irrational Exuberance" in 2000 right before the dot com bubble burst and predicted the dot com bubble would burst. He then wrote a second edition in 2006 about the mortgage market saying they're gonna collapse, and they did. You might say, "Why don't people listen to Shiller?" I did hear one economist opine once the trouble with Shiller is that he's predicted nine of the last three recessions. But the most famous, the most famous graph in Shiller's book is this one where he points out that if you deflate nominal prices from, you control for inflation and you, basically the story is that the real value of homes does not change, they've been flagged for over a century. So people think it's gonna go up, you might say why would people think they're gonna go up, the price of nothing else just goes up, and people would have theories like, well, populations are growing and so on, but as Shiller points out, you've also got a factory and cost of building comes down, all sorts of things, but so it's just not true.

It's just not true that assets keep, that homes, that real estate keeps appreciating. Goes up and down like other things and the actual deflated value by inflation is more or less flat over the last century. Another reason you might think it would lead to building up security is that people are forced to save. Americans are notoriously bad savers, and if you spend, every month, you're sending in your mortgage payment, you're paying, you're building up that nest egg, it's forced saving, so-called the third leg in the three legged stool that you're gonna need for retirement. The other being social security and your private pension. So you build up the nest egg. The trouble with this theory is that it's no longer true. And it's no longer true principally because of the 1986 Tax Reform. The 1986 Tax Reform was, tax simplification was the big issue in the 1986 Tax Reform law. So they were trying to, this is the Reagan administration, they were trying to greatly simplify the code and among other things, they sought to get rid of the home, deductions off your taxes for paying interest on debts. And so they were gonna get rid of all interest deductions. They rapidly ran into the buzzsaw, which is that the mortgage, the banking lobby is extremely powerful and the real estate industry's extremely powerful, and they were strongly opposed to getting rid of the deductibility of home interest mortgage deduction. But the '86 Act did get rid of credit card interest deduction. Used to be until '86, you could have, whatever interest you were paying on your Visa card was deductible, just like your mortgage interest is deductible. And so the '86 Act got rid of deduction for credit cards and not for home owners, for mortgages. Well, enter the HELOC, HELOC, you could all remember HELOCs, right. The home equity loans. So what people would then do is essentially borrow out the equity in their house, pay off their credit cards with it or spend it on vacations in the south of France or whatever it was, and then the HELOC would be deductible.

And so what people started to do was to, if you like, the government gave them a big incentive to raid the nest egg, and so the net result of this was, after '86, people would regularly refinance their mortgages, borrow out the equity, and so in effect, there wasn't gonna be a, there isn't gonna be a nest egg there whenever you finally sell the house, people essentially were financing this. And of course, it should be said, going back to what I said right at the beginning of the course, and forward to what I'm gonna be talking about next week, that as wages stagnated and people were going from one income to two incomes to keep the same amount of money coming in the door, the pressure to finance current consumption out of one's home equity would get ever stronger. And this is the source of Rosner, he teamed up with Gretchen Morgenson to write that book "Reckless Endangerment" in 2011, that's the best political book on the politics of the financial crisis, I think, and certainly the best book on the mortgage crisis. He had predicted in that piece I posted in 2001 that this market was gonna become unsustainable. In that piece, the subtitle of which is called "Housing in the New Millennium" and the subtitle is "A Home Without Equity "Is Just a Mortgage with Debt." so it doesn't give you any appreciating asset. A source of security. Not in an era of permanent employment insecurity. So just, let's just listen to John Travolta for a minute. - How many of you work jobs that just pay the rent no matter how many hours you put in? I see. My momma worked jobs like that after my daddy died. I remember her coming home from work just bummed, weary, you know what I mean. And I know she wanted to play with me and ask me about school, but sometimes you're just too tired to do anything but heat up a TV dinner, blob out in front of tube.

- You got that one right. - There you go. And I don't have to tell you how hard it is to be looking for work. Hey, I don't have to tell you anything about hard times. So you know what I'm gonna do? I'm gonna do something really outrageous. I'm gonna tell the truth. I know, I know what you're thinking. You're thinking he must really be desperate to do that, but if you had to swallow enough garbage - You can say shit, we're X-rated. - Yeah, me too, if you believe what you read in the paper. All right, here's the truth. No politician can reopen this factory or bring back the shipyard jobs or make your union strong again. No politician can make it be the way it used to be because we're living in a new world now, a world without economic borders. A guy can push a button in New York and move a billion dollars in Tokyo in the blink of an eye, and in that world, muscle jobs go where muscle labor is cheap and that is not here. So if you wanna compete, you're gonna have to exercise a different set of muscles, the one between your ears. - So that is "Primary Colors," an anonymous book, it turned out later was written by Joe Klein about the Clinton candidacy. And the reason I put that up there is because of the contrast between Clinton, and he did actually say that, I couldn't find an actual clip of the New Hampshire Primary, so I took it from the movie, but it's a radical contradiction between his claim in the clip I showed you from 1995 saying he wants to expand home ownership to his argument in the New Hampshire Primary three years earlier that the era of long term permanent employment is gone. And if you look, this is data released earlier this year by the Bureau of Labor Statistics looking at baby boomers and the takeaway point here is that they change jobs 12 times during their lifetimes. And only the first five or so could be explained by summer college employment or something like that. So people are looking at long term employment insecurity, and if you're not gonna know whether and when you're gonna be in a position to service a mortgage, then a home without equity is indeed nothing more than a rental with debt.

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