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The Subprime Crisis in Historical Perspective

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In recent weeks, it has become difficult to avoid news media warnings of economic calamity stemming from the subprime housing market collapse. For example, *The Wall Street Journal* recently warned that the subprime crisis could rival the fallout from Savings and Loan (S&L) meltdown in the 1990s and the bursting of the tech stock bubble in the early 2000s.[1] ABC News has suggested that the proposed government actions to deal with the crisis do not go nearly far enough.[2] *Business Week* has criticized the low number of borrowers being helped by the Bush administration's back bailout plan.[3] And *New York Daily News* columnist Errol Louis warns that the crisis could become "the country's most serious economic challenge since the Great Depression."[4]

Analyzed relative to the economy as a whole, however, the current subprime crisis appears likely to have a significantly smaller overall impact than the S&L crisis or the housing foreclosures that took place during the Great Depression. This essay outlines the dimensions of the subprime crisis and provides historically adjusted comparisons to both the S&L crisis of the 1980s and the housing collapse of the Great Depression during the 1930s.

Analyzed in isolation, economic statistics mean little. The United States, for example, has more unemployed citizens than does France, even though France has an unemployment rate about twice as high as America's.[5] Raw numbers mean almost nothing: To measure the economic impact of financial events, it is important to look at them in context.

Measuring Impact. There are several approaches to measuring the impact of the subprime crisis. Congress's Joint Economic Committee (JEC) estimates $100 billion in direct losses—that is, losses stemming directly from loans going bad—to homeowners as a result of subprime crisis.[6] The JEC estimates that housing values will decline by $2.3 trillion, while the U.S.

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Conference of Mayors estimates a $1.2 trillion decline.[7] The number of foreclosures appears likely to rise, from roughly 1.2 million in 2006, to about 1.5 million in 2007.[8]

While housing value declines in the trillions appear enormous, two factors suggest that they are less significant than they first appear.

First, home price values may not actually have collapsed on nearly as large a scale as the JEC claims. Although its methodology differs from the JEC—making an exact comparison of the two numbers impossible—it's instructive that the Conference of Mayors also projects a lower number. As Anthony Downs of the Brookings Institution argues quite convincingly in a recent paper, home prices simply are not declining everywhere. Among his well taken points:

> Default rates are rising on subprime mortgages, but these mortgages—which offer loans to borrowers with poor credit at higher interest rates—form a relatively small part of all mortgage originations.

He continues:

> Unless the U.S. economy dips dramatically, however, the vast majority of subprime mortgages will be paid. And, because there is no basic shortage of money, investors still have a tremendous amount of financial capital they must put to work somewhere.[9]

Second, the collapse may not prove calamitous because people do not purchase homes primarily as investment vehicles. A share of stock that declines 20 percent loses 20 percent of its utility, while a house that declines in value by 20 percent remains just as useful to live in. Many people do borrow against their houses for business purposes, but since few lenders will let borrowers take out loans for 100 percent of home value—and many will limit borrowers to 50 percent or less—a small decline may not actually have a significant consequence on the amount people can borrow.

Moreover, when housing values decline across the board, people who sell one house to buy another may get less for the house being sold but will also pay less for the new house, which leaves them in nearly the same situation. A truly national decline in home values affects mostly real estate investors broadly construed—that is, people who do not buy a house for every one they sell. While paper losses in the trillions may exist, they do not affect most of the nation directly or substantially.

Yet by the same token, counting only the "direct losses"—$100 billion that the JEC estimates homeowners and neighbors will lose through foreclosure—understates the consequences of the subprime meltdown. Foreclosures also impact lenders, who lose an average of 30 percent of home value, as well as those lenders' investors and employees.

Thus, the best estimates of the actual, likely economic damage that will stem from the nation's subprime ills rely on the total direct economic losses to investors and local governments. Some major investment banks—including UBS AG, Goldman Sachs and Morgan Stanley—have estimated between $400 to $600 billion in losses.[10] Compared to the losses that the nation

suffered in the meltdown of dot com stocks and the collapse of savings and loans in the 1980s, it is something the economy can absorb.

Historical Perspective. On the surface, the savings and loan crisis of the late 1980s and early 1990s—the cost of which the Federal Deposit Insurance Corporation estimates at $519 billion—seems about the same size as the investment bank estimates of the current crisis. (These figures include all assets in the at-risk class, not just failed loans.)[11] From 1986 to 1989 the U.S. economy grew from $4.5 trillion to $5.5 trillion.[12] This means the S&L crisis involved assets of between 8 percent and 10 percent of GDP. Today, the United States has a $14 trillion economy, so the subprime crisis represents about 3.5 percent of GDP.[13]

The nation's current foreclosure rate does not appear particularly worrisome when viewed in historical perspective. Because the economy is larger, one should expect there to be more foreclosures: in 2005, when nobody saw the housing market collapsing, banks foreclosed on just about 850,000 properties—more than banks did in, for example, 1939 or 1930.[14]

At the height of the Great Depression in 1932-1933, roughly 10 percent of all mortgages entered the foreclosure process—at the end of 1932, the single worst year for mortgages about 2.4 million mortgages were at some stage in the foreclosure process.[15] Today, the foreclosure rate stands at between 1.4 and 1.5 percent (about 1.5 and 1.6 million mortgages in forclosure); even the most pessimistic estimates do not show it rising about 2 percent.[16] Even if the total number of mortgage foreclosures does exceed 1932's apparent record of 2.4 million—and we could not find an estimate saying that it would—one should look at the number in the context of the overall economy and, relative to the overall economy, 2.4 million foreclosures would not be a major calamity

Given the greater size of the country's economy and population, and greater number of homeowners, it is indeed likely that the total number of foreclosures has exceeded the total number in *some* Great Depression year *every year* since 1980 or so. Between 1930 and 1940, the Census Bureau finds that the U.S. population rose from about 122 million to about 132 million.[17] Today, the U.S. population stands at a bit over 300 million. In 1930 about 48 percent of Americans owned their own homes (the number dropped to about 44 percent in 1943); today, about 68 percent do.[18] Quite simply, a much larger country with many more homeowners will have more foreclosures. Each foreclosure represents a serious problem for the people affected, but relative to the size of the economy, the number of foreclosures appears to sit well within historical trends.

Conclusion. While the subprime crisis demands careful attention, it appears unlikely to have major economic impacts beyond the housing sector. Home prices are only falling slightly overall and are even rising in many markets. About 87 percent of residential mortgages are not subprime loans, according to the Mortgage Bankers Association's delinquency studies.[19] The subprime crisis has a long way to go to reach the level of the S&L debacle or the foreclosure level of the Great Depression. It is not a major crisis, and, thus is no reason for drastic action—which itself could have unintended negative consequences including reduced homeownership, less liquidity in the housing market, and a reduced level of economic freedom and prosperity for all Americans.

Notes

[1] Greg Ip, Mark Whitehouse, and Aaron Lucchetti, "U.S. Mortgage Crisis Rivals S&L Meltdown," *Wall Street Journal*, December 10, 2007, p. A1.
[2] ABC News, "Who Qualifies for Bush's Mortgage Bailout Plan?" December 7, 2007, http://abcnews.go.com/GMA/Consumer/story?id=3968737&page=1.
[3] Jane Sasseen, "Does the housing plan go far enough," *Business Week*, Dec 11, 2007, http://www.businessweek.com/bwdaily/dnflash/content/dec2007/db2007126_445035.htm.
[4] Errol Louis, "The Guilty Parties," *New York Daily News,* December 11, 2007, http://www.nydailynews.com/opinions/2007/12/09/2007-12-09_the_guilty_parties.html.
[5] Organization for Economic Cooperation and Development, "Standardized Unemployment Rate (SUR): October 2007," http://stats.oecd.org/WBOS/Default.aspx?QueryName=251&QueryType=View&Lang=en.
[6] Joint Economic Committee, "*The Subprime Lending Crisis: The Economic Impact on Wealth, Property Values and Tax Revenues, and How We Got Here,"* October 25, 2007, http://jec.senate.gov/Documents/Releases/10.25.07subprimereportrelease.pdf.
[7] Ibid., and Global Insight, "The Mortgage Crisis: Economic and Fiscal Implications for Metro Areas," United States Conference of Mayors, November 26, 2007. Note that the Conference of Mayors estimate deals only with metropolitan areas (which contain about 80 percent of America's population) and thus do not jibe entirely with those of the Joint Economic Committee. http://usmayors.org/uscm/news/press_releases/documents/mortgagereport_112707.pdf
[8] For 1.2 million number see, e.g. First American Core Logic, "Home Mortgage Estate Foreclosures, 2006" in *Real Estate Statistics, 2006.* As this paper is being written in late 2007, of course, its not possible to know the exact total of foreclosures during 2007. Through the third quarter of 2007, however, the FDIC and First American both reported that overall foreclosures were up about 20 percent year over year.
[9] Anthony Downs, "Credit Crisis: The sky is not falling," The Brookings Institution, 2007, http://www.brookings.edu/papers/2007/10_mortgage_industry_downs.aspx.
[10] Laurie Goodman, "Total Subprime Losses as High as $480 billion," Research Note, UBS AG, November 14, 2007. Jan Hatzius, Research Note, Goldman Sachs, November 18, 2007. Morgan Stanley, "The Subprime Crisis," (Accessed December 12, 2007).
[11] Dr. George Freidman, "Subprime Geopolitics," Stratfor Geopolitics, 2007, http://www.stratfor.com/products/premium/read_article.php?id=293933.
[12] Office of Management and Budget. "Gross Domestic Product and Deflators Used in Historical Tables, (2005)" http://www.whitehouse.gov/omb/budget/fy2005/hist.html
[13] Official numbers are not yet available for 2007. A review of a variety of estimates—all of which come in between 1.4 and 1.5 percent is found in Bloomberg News, "Foreclosures rise 68 Percent in one Year," December 20, 2007 (As of this writing statistics are only available through November).
[14] For 2006 foreclosure statistics, see: Realtytrac.com "2005 Foreclosure Report," http://www.realtytrac.com/news/press/pressRelease.asp?PressReleaseID=86.
[15] For overall numbers see U.S. Census Bureau, "Historical Census of Housing Tables," 2000, http://www.census.gov/hhes/www/housing/census/historic/owner.html.A more detailed table is found in: Arthur B. Gallion. *The Urban Pattern,* Van Nostrand: 1963, p. 173.
[16] Conference of Mayors.
[17] U.S. Census Population Clock, December 12, 2007, http://www.census.gov/.
[18] U.S. Census Bureau. "Historical Census of Housing Tables," 2000, http://www.census.gov/hhes/www/housing/census/historic/owner.html.
[19] Downs.