Bernanke: "Easy Money did not Cause the Housing Bubble"

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In an effort to defend himself against his critics, Fed chairman Ben Bernanke spent over 2 hours at the Annual Meeting of the American Economic Association in Atlanta trying to prove that low interest rates were not the main cause of the housing bubble. Here's an excerpt from Bernanke's speech:

"Some observers have assigned monetary policy a central role in the crisis. Specifically, they claim that excessively easy monetary policy by the Federal Reserve in the first half of the decade helped cause a bubble in house prices in the United States, a bubble whose inevitable collapse proved a major source of the financial and economic stresses of the past two years…

With respect to the magnitude of house-price increases… Economists who have investigated the issue have generally found that, based on historical relationships, only a small portion of the increase in house prices earlier this decade can be attributed to the stance of U.S. monetary policy."

Bernanke is right in saying that the majority of economists now believe that exotic mortgages and lax lending standards were the main cause of the bubble. But that doesn't mean that the Fed's accomodative monetary policy didn't play a big part, too. When the Fed lowers the price of money below its inflation-adjusted value, it provides a subsidy to borrowers. That leads to a flurry of speculation which helps to rev up economic activity and lift the economy out of recession. But there are unintended consequences to loose monetary policy as well, like the emergence of gigantic asset bubbles. Whether low interest rates were the "primary" cause of the housing bubble or not is irrelevant. The point is, bubbles can always be contained by raising rates and reducing the flow of credit. No one doubts that if ex-Fed chair Alan Greenspan had raised rates by a full percentage point in 2003, the frenzied spending in real estate would have slowed dramatically.

Also, keep in mind, that Bernanke continued to deny the existence of the housing bubble well into 2005, even though housing prices in many areas of the country had more than doubled in less than 7 years. Here's a clip from an article in the Economist (2005) with some of the facts that were circulating at the time.

–"The total value of residential property in developed countries rose by more than $30 trillion, to $70 trillion, over the past five years – an increase equal to the combined GDPs of those nation…

–23 percent of all American houses bought last year were for investment, not owner-occupation, showing that speculation in the real estate market is rampant. CNBC reports that in Miami, a hotbed of condominium building, an estimated 70% of condo buyers are investors/speculators, and not residents.

–Due to various new forms of riskier mortgages, 42 percent of first-time buyers – and 25 percent of all buyers – made no down payment on their home purchase last year, the NAR disclosed, making them especially vulnerable to a downturn in resale prices.

–In California, 60 percent of all new mortgages this year are interest-only or negative-amortization. These loans are gambles that prices will continue to rise."

Home prices were shooting through the roof, but neither Bernanke nor Greenspan did a thing to dampen the spending-spree. Both men shirked their regulatory duties and simply looked the other way while Wall Street and the big banks raked in hundreds of billions of dollars on the mortgage orgy.

Bernanke again: "For our part, the Federal Reserve has been working hard to identify problems and to improve and strengthen our supervisory policies and practices, and we have advocated substantial legislative and regulatory reforms to address problems exposed by the crisis."

Nonsense. Bernanke and his allies in congress have put the kibosh on new regulations and made sure that securitization, off-balance sheet operations, capital requirements, executive compensation and derivatives-trading all stay the same. The Fed is a ferocious defender of the status quo despite the obvious risks that present activities pose for the economy.
Nothing has changed; Bernanke and Co. have made sure of that. The only thing keeping the system upright, is explicit government backing; the "full faith and credit" of the US Treasury. Without Uncle Sam's blank check, the system would collapse tomorrow.

Bernanke again: "With respect to the magnitude of house-price increases…At some point, both lenders and borrowers became convinced that house prices would only go up. Borrowers chose, and were extended, mortgages that they could not be expected to service in the longer term. They were provided these loans on the expectation that accumulating home equity would soon allow refinancing into more sustainable mortgages."

Bernanke sounds like he just can't grasp why investors behaved so irrationally. Could it be because Maestro Greenspan was using his credibility as head of the central bank to promote the various mortgage products? Here's a quote from Greenspan before the bubble burst:

"Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to the rapid growth in subprime mortgage lending…fostering constructive innovation that is both responsive to market demand and beneficial to consumers."

Hurrah, for subprime, cries Greenspan.

And who was the champion of mortgage-backed securities, a market which shrunk from $700 billion to $10 billion in the last year and a half?

Greenspan again: "The development of a broad-based secondary market for mortgage loans also greatly expanded consumer access to credit. By reducing the risk of making long-term, fixed-rate loans and ensuring liquidity for mortgage lenders, the secondary market helped stimulate widespread competition in the mortgage business. The mortgage-backed security helped create a national and even an international market for mortgages, and market support for a wider variety of home mortgage loan products became commonplace. This led to securitization of a variety of other consumer loan products, such as auto and credit card loans."

And who was Wall Street's most enthusiastic pitchman for derivatives, garbage loans, and the wide assortment of dodgy debt-instruments?

Greenspan again: "Innovation has brought about a multitude of new products, such as subprime loans and niche credit programs for immigrants. Such developments are representative of the market responses that have driven the financial services industry throughout the history of our country. With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers."

Greenspan spearheaded the public relations campaign for Wall Street, heaping praise on every leverage-enhancing innovation while turning a blind-eye on regulation. He was supported throughout his tenure by his right-hand man, Ben Bernanke. Both men are equally guilty.

True; low interest rates were not the main cause of the housing bubble, but they did create a suitable environment for the bubble to expand to catastrophic proportions and push the world economy into deep recession. Greenspan and Bernanke did not cause the crisis, but they were its enablers, which is even worse.