

MEMORANDUM FOR THE RECORD – MFR

EVENT: Interview with **Dean Baker**, macroeconomist, author and co-founder of the Center for Economic and Policy Research

TYPE OF EVENT: Group Interview

DATE OF EVENT: August 18, 2010, 1:30 p.m. – 2:45 p.m.

TEAM LEADER: Researchers Tom Stanton; Ron Borzekowski

LOCATION: FCIC small conference room, 1717 Pennsylvania Ave. NW, Suite 800

PARTICIPANTS/ NON-FCIC: Dean Baker

PARTICIPANTS/FCIC: Tom Stanton, Ron Borzekowski, writer Alexis Simendinger

MFR PREPARED from AUDIO BY: Alexis Simendinger

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SUMMARY OF INTERVIEW: Mr. Borzekowski thanked Mr. Baker for agreeing to speak with the FCIC and asked him to describe his assessment of the causes of the financial crisis, as well as factors that he believes may be important but not causes. Mr. Baker was familiar with the FCIC's statutory mandate.

At the conclusion of the interview, Mr. Stanton asked Mr. Baker to review his education and background. Mr. Baker has been co-director the Center for Economic and Policy Research since 1999. It is a nonpartisan, independent think tank with four economists on staff and another arriving soon. He previously was a senior economist at the Economic Policy Institute, and was an assistant professor of economics at Bucknell University. He earned a Ph.D. in economics from the University of Michigan in 1988.

Mr. Baker opened the discussion of the crisis and its causes by saying **he put the housing bubble “front and center.”** He said his assessment was that the housing bubble was “90 percent” of the crisis and responsible for what “hit the economy.” He said the housing bubble had been driving the economy since the end of the last recession. The last recession was created by the collapse of the stock bubble. Mr. Baker said when the stock bubble burst, the recession was later measured as short and relatively mild. He noted that the official dating of the recession after the stock bubble was March 2001-November 2001, which he added “is about as short as a recession can be.” Yet, the economy did not resume creating jobs until the fall of 2003, nearly two years later.

In the current situation, “It’s very difficult to recover from a recession that was the result of the collapse of the financial bubble, an asset bubble,” he said.

During the 2003 period, he continued, house prices increased – diverging from fundamentals -- and there was a surge in construction. From 2002 to 2006, new houses were being built at record rates. On top of that, he added, there was a “huge increase in consumption, so that savings rates fell through the floor.” Some might have expected to see savings rates rise because “we just lost on the order of \$10 trillion in wealth with the collapse of the stock bubble,” he said. Some of that wealth came back, Baker added. In 2005-2006, instead of the savings rate rising, it hit zero. “This has all been driven by the wealth created by the housing bubble,” Baker said.

Consumers today, he added, “don’t have money. **They had wealth; it’s now disappeared.**”

The housing bubble was driving the economy, and Baker added that aggravating factors included “really bad, if not outright **fraudulent financial practices**” including deterioration of loan quality; no-document loans, etc. Baker explained that the financial practices helped expand the bubble even more.

“It is inconceivable to me that this was not known to the actors, because I knew about this.”

Baker said that at the time this was occurring, he received emails from around the country telling him about friends and relatives who worked at Countrywide, “or other issuers,” who were being told, he said, “to fill in numbers for people who would not have otherwise qualified for mortgages. This was clearly a policy,” he said.

Baker said this occurred during 2004, 2005 and 2006. People sent Baker anecdotes about lending practices because they happened to read things he wrote and decided to pass information along hoping he would follow up.

This also raises the issue of whether the securitizers also knew what was happening, he said. That’s why, he added, he’s inclined to believe “there’s a **big element of fraud** here,” or at the very least, “it was deliberate not-knowing.”

Baker said he did not at the time have any direct conversations with anyone in the banking/lending community who confirmed the existence of any such policies or practices.

“So much of this was absolute public knowledge in the sense that we knew the number of loans being issued with zero down. Now, do we suddenly have that many more people -- who are capable of taking on almost zero down who we think are going to be capable to pay that off -- than was true 10, 15, 20 years ago? What’s changed in the world? **There were a lot of things that didn’t require any investigation at all; it was entirely available in the data.**”

Baker said he first recognized the stock bubble in 2002 and for the first two and a half years “looked stupid” because he kept predicting it would burst in six months. With the housing bubble, he issued warnings, but because of his previous experience miscalculating the expected timing of a calamity, he

offered no predictions about when the housing bubble would burst. Baker said it took longer than he had imagined.

“It should have been evident to everyone involved that these were bad loans,” he repeated. “That allowed the bubble to last much longer, prices to go much higher, and obviously create much more damage when you eventually had the collapse.”

Baker said the real economic story of the crisis is **the loss of wealth**. There are problems with the financial system, which some continue to worry is not working, but Baker said he believes the economic downturn is not the result of the challenges in the financial system, but rather due to the loss of \$6 trillion in wealth. With that extent of loss, “you expect to see a lot of people consuming less, and that’s what we’re seeing.” Baker added that when the stock market plunged, there was an additional \$6 trillion in loss of stock wealth. The rise in savings rate is understandable. The falloff in construction is understandable. The falloff in nonresidential building, also explicable, he argued.

“To my mind, **most of the story is with the real economy,**” Baker repeated. “I see the financial aspects of it being to some respects secondary. I understand it’s the ‘Financial Crisis Inquiry,’ but I’m more inclined to **call it an economic crisis,**” he said.

Q. Borzekowski: Regarding the run-up of consumption through 2007, was that financed primarily by equity extraction?

Baker said that with the increased valuation of homes, you would have expected people to have looked at the rising valuation of their homes and not saved as much for retirement, for instance, because they assumed their homes were doing it for them.

He also raised as a factor the demographics of the baby boomers, those right at the edge of retirement. He said they have “very little wealth,” looking at some analysis the Fed’s survey of consumer finance has done. The median older baby boomer, between 55 and 64, has wealth, including housing equity, of about \$170,000. That’s very little, he added. For younger baby boomers between ages 45 to 54, it’s about \$180,000, also very little. Baker said it is understandable that they are trying to save now, particularly when there are public policy issues being raised about cutting Social Security.

Q. Stanton: When you examine the data, what is the information you have about the nominal increase in wealth during the bubble, versus the decrease now?

Baker said that he believes about 75 percent of the bubble has deflated. He added that there are issues about which index is the right index to study. The Case-Shiller index only dates to 2003-2004. He said he was using the House Price Index (OFHEO) before that. The Case-Shiller index is better, he said, because the House Price Index and excluded a lot of the subprime because it looked at conformable loans. On the downside, it did not pick up bank-owned properties. He said he could not answer perfectly, but thought about three-quarters in real terms of the wealth “has disappeared.”

Q. Stanton: I’m trying to get at the extent to which people lost wealth they never had because of the bubble, and the extent they might have lost more wealth than they gained during the bubble.

Baker said it would be hard to break that out. Using the example of someone in some part of the country who saw his/her home double in value, and then it fell back to where it was. If that person looked at that change, having done nothing different, they might be upset, but if it went back to where it was, they might be alright. But it was not as if people did not respond to the escalation; they spent as if that wealth were real, Baker said. The bubble did not directly kill their wealth, he said, but those individuals spent as if that wealth were real, and did not save when they certainly should have saved in their peak earning years. They relied on the perceived equity in their homes.

Q. Borzekowski: From an economist's viewpoint, are people who are cashing out their equity based on the perceived rise in value of their homes acting rationally?

Baker said "absolutely." If that wealth had been real, it would have been a perfectly reasonable thing to withdraw some of that wealth.

Q. Borzekowski: Were there signs beginning in 2002 and 2003 that housing was beginning to bubble?

Baker said when he began looking in 2002, he saw that real house prices had risen 30 percent from their mid-1990s level. Case-Shiller has since gone back and constructed its index going back to the 1890s. But at the time, he said he was looking at government data going back to the 1950s. Looking at that, and from the early 1950s to 1996, house prices largely tracked the overall rate of inflation. By 2002, there was a record vacancy rate in rentals, which should have raised some eyebrows. If you're seeing a big run-up in prices, that's usually inconsistent with an oversupply. **Baker said he thought already by 2002 that there were some "pretty big signs that something wasn't right."**

Q. Borzekowski: What do you think about the argument that with the growth of securitizations and from the mid-1990s onward, there was additional capital available for housing and new source of financing outside of the traditional savings and loan banks, and like after WWII, with a structural break in homeownership, it would be acceptable to see a house-price change, maybe 30 percent over five years?

Baker said the period was one of innovation in the supply of mortgage financing, including HUD. He said securitization began in the 1980s, and spread beginning in the late 1990s. Baker said he thought the FCIC would be hard-pressed to find any uptick in housing prices associated with any of those prior innovations. He added that if that linkage were true, you'd expect to see a "much stronger relationship between house prices and interest rates." You don't find anything like a 30 percent increase even with some large changes in interest rates, nominal or real.

Q. Borzekowski: Are there any other areas of potential causes that you've looked at?

Probably in 2004, with the decision of the SEC to allow the banks to become more heavily leveraged, that obviously played a role in the securitizations, Baker said. But prior to 2002, he said he did not see big changes in the regulatory structure that permitted activity that otherwise would have been prevented.

Q. Stanton: Thinking of Alan Greenspan's comment that what surprised him the most were the number of institutions that failed to protect the interests of their shareholders or their own interests, what is your sense of what happened?

Baker said his answer would be speculation. He guessed that people were thinking short-term, and were thinking of bonuses short-term and the concept that there was one-sided risk in this story. "If you make the same mistake that everyone else does, you don't pay a price for it. ... But if let's say you were to be right [about the risks] ... [you] would have drawn a huge amount of heat."

"Even if you proved to be right, you might still be out of a job. **I think you had a situation of very asymmetric incentives.**"

Baker said that looking around at the landscape, one has to ask, "How many people who took their companies down, even [Lehman's former CEO Richard] Fuld – he has another job with a hedge fund, right -- ... actually suffered in any notable way from having made really, really wrong decisions for their companies?"

Baker mentioned, for instance, that at Citigroup, former Treasury secretary Robert Rubin made \$110 million.

"Most of us I think would probably like to be suffering the way they're suffering."

Q. Stanton: Can you say the same thing about homeowners who saw house-price appreciations and took on risks they did not understand and extracted money from their homes? Is that the same phenomenon, when the perception is that everything is going up?

Baker said there are important differences. The homeowners aren't in the position to independently evaluate the housing market. That is the job of the top executives at major banks. That is their job. A homeowner is in the position of being an "information taker" and not an "information generator," which is a very important difference, he said.

Baker said he did not believe most of these executives thought the situation was about to blow up. But they had reason to entertain that possibility because they could insulate themselves, and in that sense, they knew that it might turn out poorly. So, in other words, they knew in some way bad things were out there, even if they had not thought it through. They thought they were largely insulated from that, and they had a different set of options than did the homeowners out there, Baker said.

Q. Simendinger: Do you believe that as homeowners watched the escalation in housing values they trusted that there were watchdogs out there, scrutinizing all the operations?

"Absolutely," Baker said. They were being told: "House prices never fall." Baker said he argued with a lot of people about that assertion. Baker said he debated the chief economist at Freddie Mac a number of times. David Lereah, the chief economist for the National Association of Realtors was saying that housing prices don't fall. The guy at Fannie Mae (Baker could not initiall recall his name) was more

cautious, but still reassuring to consumers. “And of course Alan Greenspan himself was saying everything is basically fine.”

Q. Stanton: What period was this that you were debating with these economists?

Baker said he recalled the first time was September 2002 at a meeting with the FDIC about the housing market, continuing to 2006.

Baker said, “In fairness, Burson [Baker recalled his name with prompting from Stanton], the chief economist at Fannie Mae, was more cautious.”

Q. Simendinger: Can you talk about the regulatory elements of the financial crisis?

Baker said he placed a “lot of blame at the doorstep of the Fed” because its responsibilities by definition include preventing financial, asset bubbles from happening – bubbles such as with the stock and housing markets – because such bubbles are inconsistent with maintaining price stability and full employment. Baker said the Fed could have used foresight to detect the brewing conditions, not just hindsight after the crisis.

“They either did not see or did not take actions against the bubble.”

Q. Simendinger: Do you believe the Fed could not see it?

Baker answered firmly, “No.” Greenspan absolutely saw the stock bubble, Baker said, and that’s clear to those who read the FOMC minutes of that period. Baker recalled that Greenspan gave a speech at the ASSA in January 2004 saying ‘We saw the stock bubble. We thought the best thing to do was let it run its course and pick up the pieces.’ Greenspan was pleased with the Fed’s assessment heading through the stock bubble, Baker said, adding that at the time he did not share the then-chairman’s assessment.

The economy did not create jobs from March 2001 until September 2003, and did not reclaim all the jobs that were lost until January 2005, Baker said. So to say it was the right thing to do, Baker said, overlooked people out of work for a long period of time after the stock bubble.

Greenspan saw the stock bubble, so Baker said he is dubious that the Fed did not have discussions about the housing market. Baker said he had not gone back to read all the FOMC minutes/transcripts that have been released dating from that period, but should. “They had to have talked about it; it’s inconceivable that they did not talk about it.” Baker said he did not know if the Fed at the time was convinced a bubble did not exist.

Baker said it was obvious to him that the Fed had discussions about the housing situation. Baker added that he “did not see any serious evidence on the other side,” meaning evidence that the Fed missed the signs. He added that in his own reading of available data at the time, the situation was not ambiguous: “You had a momentous change in valuation, in the largest market in the world, more than we’ve ever seen before, and there was nothing that fits in terms of the fundamentals story.”

Baker added that he first began looking at the housing situation closely because Greenspan gave testimony in the spring of 2002, where he went through the arguments that there was no housing bubble and it was explained by the fundamentals. Baker said he did not recall which testimony it was or whether Greenspan answered a question or offered the information on his own.

Greenspan said in that testimony that incomes had been rising. Baker added that incomes rose at a healthy pace in the late 1990s, but that it was no unprecedented in the post-war period. That had ended by 2000, and there was a recession. So what explained the increase in 2001, 2002? Baker said, challenged the Greenspan thesis. He noted that Greenspan tried to say it was population. Baker challenged that idea, too, arguing that baby boomers were through their period of home-buying by then. Baker said Greenspan then added immigration to his list, and Baker challenged that, too, arguing that it was hard to make the case that the market was swamped with immigrants buying \$400,000 homes. (Baker laughed and said it turned out that some were, but that was part of the problem, and not the explanation.)

One other feature Greenspan mentioned in that 2002 testimony was housing supply, saying that there were environmental restrictions on building. Baker said that was not a factor that was new.

Q. Stanton: So, what was going on?

Baker said there was a bubble driven originally by the stock bubble. He said it was similar to what happened in Japan, in which each bubble fed off the other, and in 1990, when one burst, the other burst. In the US, when the stock bubble burst, Baker believes it reinforced the housing bubble in two ways: it sent interest rates plummeting, which made it easier to buy homes; and there was an attitude shift, as he put it, that stocks were speculative, but housing felt safe because people lived in their homes.

Q. Borzekowski: Some have argued that there must be something qualitatively different with the housing bubble compared with the tech bubble, in that the recessionary impact is not comparable. What's different?

Baker said that with the housing bubble there was more real economic activity, driven by construction, than there was in the tech bubble. In the tech bubble, there was some investment that was desirable and other investment that was crazy. In residential construction, at the peaks, the share of GDP was climbing to 6.2 percentage points, just in the residential side, against what would have been expected, around 3.5 percentage points, given prior trends, Baker said. So that was a change of 2.7 percentage points in GDP. Plus, given overbuilding, the sustainable rate going forward is probably more like 2 percentage points. The economy has sustained a huge falloff in demand in construction, both residential and non-residential, Baker summarized.

Also, the housing wealth effect is considerably larger than the stock wealth effect, because stocks are mostly held by higher-income individuals. Even with a comparable loss of wealth between the two meltdowns means the housing impact was more widely experienced and had a larger impact on consumption.

Q. Borzekowski: What you're describing means that there could have been a severe recession simply with the popping of the housing bubble, without the near-destruction of the financial system. Between August 2007 and the end of 2008, securitization comes to a halt; the asset-backed paper market ceases; the investment banks go away; the commercial sector gets harmed substantially, and never mind the originators and the thrifts. I think I named them all. What's your view of that, and the role of the credit crunch after that and credit going away from all these firms?

Baker said no one in that period could not have seen the sharp acceleration. He said the events got the US where it "would have been anyhow," and to a large extent, the financial system is pretty much operating.

He said he believes the government was effective in countering the impact on the financial system so that there is currently a system that is operating. Baker said a credit crunch is what happens during a downturn. He said he did not want to argue that there was zero consequence of the financial crisis, but he believes it is very much secondary. He said that there are many banks in trouble but many that are not, and if circumstances were presenting opportunities to those healthy banks to lend and gain market share, he said you'd expect to see obvious evidence of that. But he said he does not. And also, on the side of small businesses, some are having trouble getting credit, but for large businesses, it has never been easier to get credit at low interest rates. So if smaller competitors were being hobbled by a lack of access to credit, and could not take advantage of investment opportunities, you should expect to see the big companies plunging in and taking advantage of that, and they are not doing that, he said.

He noted that WalMart had just reported that it was not planning to expand to take advantage of smaller retailers.

These factors, Baker added, persuade him that this is not really a financial story.

Q. Simendinger: How long will the recovery take, as you project forward?

Baker said if the US does not "do some serious stimulatory policy, something like what is currently on the agenda, I think we could be sitting here with high rates of unemployment for six, seven years out."

You need something to replace that lost demand, and investment is not going to do that. Over time, with a growing population, the oversupply of housing will be eroded, he added. That's a process that will take five to seven years. Also, he said the US has an overvalued dollar and the US should be seeing the dollar fall. In principle, he said, that is where you would normally expect to see some of the demand made up. That will depend on factors including political decisions by the Chinese government, conditions with the Euro. Baker said it would not shock him if the dollar is higher five years from now.

Q. Simendinger: With that time frame in mind, you're describing a lost generation, economically, right?

Baker: "Yeh, this is a really serious downturn and it's not something you get over quickly."

He said with “aggressive policy,” the US could recover more quickly, but he added “he also knows the politics.” The prospect of getting a large stimulus through Congress is “very poor”; the Fed could embrace more aggressive policy, “but there seems to be little willingness to do that.” He noted that Ben Bernanke, when he was still at Princeton, wrote about targeting a higher inflation rate. Having a three or four percent inflation rate, Baker said, would “go a long way towards reducing real interest rates, and reducing the debt burden and give people some equity back in their homes.

Q. Simendinger: Do you see now any of the seeds of the next crisis to come? If the stock bubble rolled into a housing bubble, what is the continuum?

Baker said it is hard to see. He mentioned the runaway gold market, but said if it fell 15 percent, he does not see any large economic consequences. Stock can move the economy, and housing can move the economy, he said, but there are not many other items that can have that type of impact if there is a bubble. In other words, other bubbles can be contained within that sector.

Arguably oil, petroleum, might fit the definition of something that impacts the whole economy. But not gold, which does not impact many people’s measures of wealth.

He said he does not believe it is the Fed’s job to police every commodity market. But housing and stocks move the economy, and it is part of the Fed’s responsibility to oversee the macro economy.

Q. Stanton: When a mortgage broker and borrower come to the table, how do we figure out who is committing fraud in some situations?

Baker said “people do lie sometimes.” If it is very frequent that a certain lender had a lot of loans going through with bad information, he said you have to assume it is policy and not error.

Q. Borzekowski: From the originators’ point of view, what is the rationale to keep pushing such a loan down the pipeline?

Baker said “commission.” They are paid to push through bad loans because they get commission and there are no bad consequences.

Q. Stanton: But what about the underwriter?

Baker said the securitization was essential to this story “because they knew they could pass along almost anything to the investment banks, and very few questions asked, obviously.”

Q. Borzekowski: Why are they still willing to buy them if there’s a reputation of bad loans?

Baker said he used to believe, and feels “stupid” not to have known differently, that bond rating agencies actually did due diligence and examined the foundation of what they rated. They do not. Under those circumstances, he said, there was little incentive for the investment banks to pay attention to the loan quality.

“The only one who gets stuck at the end of the day is the buyer, often institutional investors, and buyers of the mortgage backed securities who did not realize what they were doing and should have.”

Baker said at the other side, with appraisers, the lenders wanted the appraisers – independent contractors – to produce a high number on properties, which they did because they wanted to get hired and there was no penalty.

Q. Stanton: How do we get documentation of that?

Baker said the FCIC could find appraisers who would tell the commission that. It was not a secret. “They knew that they had to inflate their appraisals if they wanted to get hired.”

Q. Simendinger: What is your reaction to the statements from some officials and regulators that they did not believe financial institutions would act in ways that were self-injurious and against their self-interests?

Baker said there were individuals who were working for the firm and the top executives at firms were acting in their own self-interest, but in opposition to the interests of the firm. That is a “really big problem.” This was a case of taking it to the extreme because Baker said he believed they knew in some way that their trading and bets were risky. “They did not have to consider that because that risk had very little down side for THEM.”

There were very asymmetric incentives, Baker repeated.

Q. Stanton: Do you have recommendations you’d recommend in general?

Baker said bar bond rating agencies from being chosen by the issuer.

Issuers/banks should be required to keep a stake in loans that are securitized. He added that while he believes it is a good idea to have a stake of 5 percent, or what the new law requires, there is no guarantee that someone won’t short that required position.

Baker said he recommends looking at the financial sector overall to study the waste – the lack of value to anyone’s best interests of innovations such as synthetic collateralized debt obligations. In that regard, Baker said he is an advocate of a “modest” financial transactions tax to raise the cost of these products to reduce incentives.

He also wants corporate executives to be more responsive to shareholders. Rather than selling stock if you don’t like management, he would prefer that shareholders have more control over executives.

Q. Stanton: What is that solution?

Baker said shareholders should directly elect executives; have only directly voted shares count in those elections. He wants it to be more difficult for corporate insiders to rig the “inside game.”

Q. Stanton: What was the role of Fannie and Freddie in the crisis?

Baker said they aided the bubble. The worst loans were being securitized by the private market and Fannie and Freddie didn't get there until later, in search of profit and market share, he said.

If they had acted to be sure mortgages were issued based on price-to-rent ratios, even regionally, the bubble never would have gotten as far as it did, Baker said. They were more followers than leaders, he said.

Q. Borzekowski: What should the FCIC be sure to focus on?

Baker said the FCIC should focus on the power the regulators had and what they did and didn't do. He said the regulators had the power to prevent much of what happened. Greenspan had the power, he repeated, "to stop this."

Baker said there are two justifications for the FCIC to spell this out: one is history and the other is that "we need the right incentives for regulators to do the right thing." It is not easy for government regulators to tell powerful forces that they cannot do something. There will never be total clarity; there will never not be an argument.

He wants regulators to feel the heat if they do not do "the right thing" and something goes wrong because they did not act. "They'll pay a big price."

Q. Simendinger: You are talking about regulator incentives in real time?

Baker: Yes, proactively. But in hindsight they should know that they will be fired if they do not do their jobs.

"To my knowledge, no one has been fired for this."

The short-term consequence, politically or to the confidence of markets, of firing someone in a regulatory position for saying yes and not no is less than it would be to the country if problems are pushed further down the road, Baker said.

Baker said "calling attention" to growing problems is a first defense. Example: documenting the existence of a bubble, if the Fed had been willing to do it.

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