



# Book The Subprime Solution

## How Today's Global Financial Crisis Happened, and What to Do about It

Robert J. Shiller  
Princeton UP, 2008  
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### Recommendation

Robert Shiller, the prescient author of the book *Irrational Exuberance*, offers an insightful examination of the causes of the subprime mortgage crisis, and suggests a list of potential measures for the future. He lays the blame for the subprime crisis on the same oblivious fiscal attitudes that led to the technology bubble of the 1990s and the real estate bubble of the 2000s. Both bubbles involved excessive lending and resulted in severe losses for capital providers. His prescription for dealing with the crisis involves a range of policy measures. In the short term, he calls for bailouts for low-income borrowers who got drawn into subprime scams that they did not understand. For the long term, he proposes a new framework for financial institutions, more transparent information, simpler contracts, improved risk-management markets, equity insurance and home loans linked to income, among other measures. Both his diagnosis and his prescription will be controversial, no doubt, but *BooksInShort* thinks his book is a necessary text for anyone who wants to understand what’s happened, and how to survive it and learn from it.

### Take-Aways

- The subprime crisis may be the worst U.S. financial catastrophe since the Great Depression.
- This crisis is a consequence of the U.S. real-estate bubble.
- Hardly anyone recognized this bubble as a bubble when it was happening.
- The subprime crisis eroded social capital and trust.
- Restoring trust in the system and controlling the subprime crisis’ fiscal consequences will require bailouts, though they are generally undesirable.
- Like the Depression, this crisis provides an opportunity for institutional reforms.
- The U.S. needs a better financial information infrastructure to provide accurate information to uninformed consumers and mortgage buyers.
- New institutions could give credit to mortgage lenders and provide risk management tools to individual borrowers.
- Financial market reforms and better financial technology could improve the U.S. economic.
- Current events call for the effectiveness and generosity Americans have shown in the past, as in the Marshall Plan.

### Summary

#### How Did the U.S. Get into This Mess?

The United States’ decade-long real-estate bubble brought about the subprime mortgage crisis that began in 2006. The bubble’s severe consequences will go far beyond the intense financial wreckage it caused. Its ripple effects constricted credit globally and led to the failure of several major financial institutions. The impact is so drastic that a return to normalcy may take years, even decades. Expect a prolonged period of slow economic growth. For a suggestion of what may be coming in the

wake of the subprime crisis, look at the “lost decade” in Mexico after the 1980s oil bubble, and the 1990s stagnation in Japan after its 1980s equity and real-estate bubbles.

“The very people responsible for oversight were caught up in the same high expectations for future home-price increases that the general public had.”

However, the damage this crisis has done to the social fabric is even more severe than the damage to the financial system. The subprime crisis has much in common with the reparations crisis in Germany after the Treaty of Versailles ended World War I. John Maynard Keynes quit as a member of the British delegation to signal his strong opposition to the impossible burden the treaty placed on Germany. Keynes wrote *The Economic Consequences of the Peace* to explain why these vindictive reparations would turn out to be disastrous. Events proved him prophetic. Saddled with debt that Germany could not possibly repay, feeling keenly the injustice of the reparations, victimized by circumstances beyond their control, the German people nurtured bitter resentments that helped put Adolf Hitler in power and bring about World War II.

“Most people do not understand the true nature of the bubble and try to think of speculative events as rational responses to information, for they do not understand contagion of thought.”

When people lose trust in their economic and social systems, the consequences can be terrible. That trust is now at risk in the U.S. During the real-estate bubble, many people took at face value the assurances of politicians, policymakers, pundits and financiers that the country had entered a new era in which home and real-estate prices would rise continuously, an era in which anyone, regardless of income, could become a homeowner and live the American dream. Clearly, no such new era existed. The dream has turned into a nightmare. Many people have lost not only their homes, but also their life savings and, more ominously, their self-respect and their trust in the system – the trust that is the foundation of civil society.

“It does not help matters if leaders continually assert that a turnaround is just around the corner.”

The solution to the subprime crisis must address this crisis of trust, so it must go farther than merely repairing damaged financial institutions and restoring credit flows.

## Bubbles and Contagion

Speculative bubbles are nothing new. Perhaps the most storied speculative bubble was the Tulip Mania in the Netherlands in the 17th century. However, despite the work of financial historians and economists who have studied the phenomenon of bubbles – and notwithstanding ample evidence that the U.S. was indeed in the midst of a real-estate bubble – no one seemed to be able to see the bubble for what it was at the time. The bankers, economists, central bankers and economic policymakers missed it, just like the uninformed home buyers.

“That...strategy...has been trotted out by virtually every leader in government and business...when faced with the necessity of truly fundamental reform.”

The factors that contributed to the severity of the bubble included:

- Policies encouraging home ownership even for people who arguably should not have owned homes.
- Mortgage securitization that broke the link between the mortgage originator and the recipient of payments. This left mortgage originators with no incentive to pay attention to whether borrowers would be able to repay their loans.
- Financial engineering practices that allowed for extremely low interest loans, or even no interest loans, that would eventually reset at much higher rates.
- A glut of new homes that eventually led to sharp price drops.

“The principal short-term remedy for the subprime crisis is, unfortunately, some combination of bailouts.”

The real-estate bubble expanded because of a widely held belief that real-estate prices would continue to rise. Such faith in rising prices is characteristic of bubbles, of course. People buy because they think they are going to be able to sell later at higher prices. However, this belief ignored the history of the U.S. real-estate market.

“Government promotion of a fundamentally improved information infrastructure can capitalize on [recent] advances...in both information technology and behavioral economics.”

In 2004, when author Robert J. Shiller sought reliable historical data on U.S. real-estate prices, he learned that no precise catalogue of housing prices existed. So, he built his own (now known as the S&P/Case-Shiller Home Price Indices). A graph of home prices shows that they historically correlate rather closely with population, interest rates and construction costs. Around 2000, housing prices rose astronomically even as construction costs were declining. And in 2003, just as home prices were rocketing up, the Fed slashed interest rates, adding fuel to the rocket.

“Many mortgage borrowers blandly accepted the mortgage terms that were offered them...even when no consumer protections whatsoever were in place.”

Then-Fed chairman Alan Greenspan did not put any credence in bubbles. He assumed that, on the whole, prices reflected the aggregate of rational decisions about real-estate investments. Some attributed the price increase to the U.S.’ limited supply of real estate since the steepest price increases were happening in and near urban areas, and less than 3% of land in the U.S. is urban. But the supply of urban areas is not fixed. In fact, developers find it relatively easy to construct new urban areas, and they’ve done so all over the world. Examples in the U.S. include Reston Town Center, in the Washington, D.C. area, and Mesa Del Sol, in the Albuquerque, New Mexico area. Cities also sprang up on bare ground elsewhere, such as Dongtan near Shanghai, and Konstantinovo near Moscow. A rational supply-and-demand assessment of urban land could not support the magnitude of price increases that occurred.

“The government needs to set up a new system of economic units of measurement...akin to the creation of the metric system after the French Revolution.”

Could prices have been driven up by a shortage of construction materials? No. The materials used in construction are abundant and, in some cases, renewable, as with lumber. What about the price pressure from Chinese and Indian buyers, as those economies developed and their affluent residents sought to relocate to America? No

evidence supports that proposition. In fact, most people prefer to buy homes in their own countries.

“Markets for occupational incomes – such as futures, forwards, swaps and exchange-traded notes – will ultimately make it possible for people to hedge their lifetime income risks.”

Although economic fundamentals don't seem to support the housing bubble's price rise, one factor does seem common to all bubbles: “social contagion.” Some skeptics, including Greenspan, do not believe that social factors weigh heavily in economic decisions. However, a glance at the political map shows that support for liberal or conservative candidates seems to correlate with regions. For example, the U.S. has Republican and Democratic “red states” and “blue states.” Moreover, as times change, society emphasizes some notions and puts others aside, so social notions about what is important change with the times.

“A continuous-workout mortgage would have terms that are adjusted continuously (in practice probably monthly) in response to evidence about changing ability to pay and changing conditions in the housing market.”

Think of social contagion in terms of an epidemic. Certain ideas infect a few people, then others, who continue to spread them. By the time most people are infected, the infection seems normal, and those who are not infected seem odd. Everyone who is infected thinks along the same lines. News channels feature the same kinds of stories and the people who offer opinions all seem to share the same assumptions. Thanks to social contagion, these ideas become “truth,” not because they have withstood rigorous analysis, but because everyone accepts them as true. They seem so obvious. How could so many people be so wrong?

“We must always be concerned about public perceptions of fairness and evenhanded treatment, about public confidence that our economic system is moving forward to provide opportunities for all.”

Moreover, as long as the real-estate bubble was expanding, investing in it made sense. But as more people invest more money in any bubble, it expands. Betting against the U.S. subprime bubble was extremely difficult. Either no instruments existed to allow skeptics to sell real estate short, or the markets for such selling remained illiquid. So, people accepted the real-estate bubble not as a bubble, but as a normal and even healthy development. Greenspan, a bubble skeptic, cut interest rates. Bank regulators took a hands-off approach to real-estate lending. Risk managers at Freddie Mac discounted the possibility of steep price drops, arguing that, after all, drops of such magnitude had not occurred since the Great Depression.

## What Is the Next Step?

The subprime crisis may be the worst financial dislocation since the Great Depression, but that means it provides a comparable opportunity for reform. The U.S. didn't have long-term mortgages before the Depression. Homeowners took out short-term financing and rolled it over, but the credit climate of the Great Depression made that impossible. With banks failing, a 30% drop in the price of homes and an unemployment rate as high as 25%, many borrowers could not extend their mortgages any longer. Confronted with this crisis, government and business worked together to develop innovative solutions to minimize evictions and help the recovery effort. These innovations included:

- A Federal Home Loan Bank System modeled on the Federal Reserve System.
- An association of real-estate appraisers to make that occupation more professional.
- Bankruptcy reforms that allowed ordinary citizens to seek protection from creditors.
- The advent of various helpful institutions, including: the Home Owners' Loan Corporation, the Federal Housing Administration, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Federal National Mortgage Association.

“That (public) confidence is being seriously eroded in today's subprime crisis.”

The present subprime crisis calls for change on a similar scale, including these steps:

- **Bailouts** – Bailouts will be necessary, even though they are disagreeable. Yes, bailouts will compel taxpayers to pick up the tab for other people's bad financial decisions. But, in many cases, the people whom the bailouts will help made those bad decisions because they were uninformed and aggressive lenders exploited their ignorance. Leaving the victims to fend for themselves now that the loans have gone bad would be merciless and would further erode trust in society. Moreover, it would mean accepting potentially very dire systemic consequences.
- **“Financial information infrastructure”** – The U.S. needs a new financial information infrastructure to prevent or mitigate future bubbles. This should include new risk management markets, such as a market in real-estate derivatives. At present, investors can buy contracts in real-estate futures, but they are not very liquid. The system should include markets in other risks, such as livelihood risk, GDP risk and so forth. People should be able to buy home equity insurance. The financial system should offer “continuous-workout mortgages” with payment schedules that would adjust to reflect market and personal income shifts. The government should subsidize financial advice much as it now subsidizes (through Medicare) medical advice. At present, higher income people receive a tax reduction for the financial advice they purchase, but lower income people, who may need such advice most, do not receive any subsidy. If lower-income people had been given access to sound financial advice before they signed subprime loans, the entire subprime crisis might well have been averted.
- **New institutions are necessary** – The Home Owners' Loan Corporation (HOLC), established during the Great Depression, made loans to mortgage lenders and took their existing mortgages as security. However, the HOLC required that these mortgages meet certain criteria for sound, reasonable lending. The U.S. also needs a watchdog agency, similar to the Consumer Product Safety Commission, to ensure that careless or exploitative financial institutions do not offer dangerous financial products to unsuspecting consumers. New retail institutions for risk management could do for ordinary borrowers what grain elevators do for farmers: serve as intermediaries between the individual and the risk management market.

“Putting aside our political and policy differences, we must fall back immediately on a more basic social contract...that we as a society will protect everyone from major misfortune.”

The subprime crisis may well be the worst financial catastrophe to hit the U.S. since the Great Depression, but like the Depression it provides an opportunity for reform that can leave the American economic system and society-at-large in much better condition.

Therefore, the response to the subprime crisis should not be to roll back the clock, and punish the technologies and markets that have the future potential to reduce risk, improve economic equity and provide the foundation for a sounder, fairer financial system. The solution to the market failure lies in better and more liquid markets – not in market constriction.

## About the Author

**Robert J. Shiller** is the best-selling author of *Irrational Exuberance* and *The New Financial Order*. He is the Arthur M. Okun Professor of Economics at Yale University. He is the winner of the BooksInShort International Book Award 2003.

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