

Testimony of Mark Zandi
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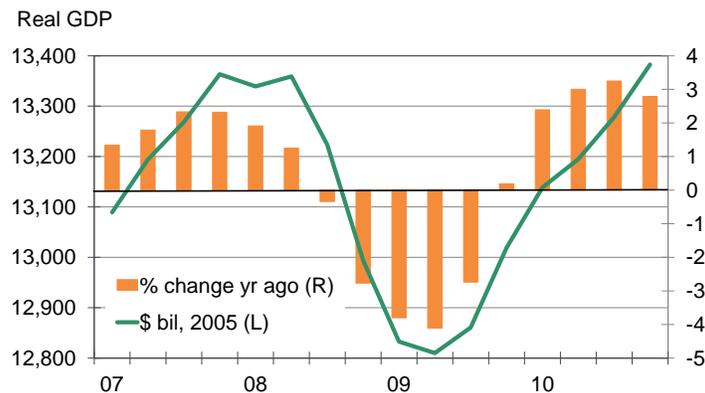
Before the Senate Budget Committee

"Challenges for the U.S. Economic Recovery"

February 3, 2011

The U.S. economic recovery is steadily gaining traction. Real GDP has finally recovered from the steep drop suffered during the Great Recession, and economic growth is accelerating (see Chart 1). The economy is expected to expand at a rate that is well above its potential this year, meaning that businesses should soon begin adding sufficient numbers of new jobs to significantly reduce the unemployment rate. Although the jobless rate may still move higher in the next few months as people who lost jobs during the recession return to the labor force, unemployment is expected to fall below 9% by year's end.

Chart 1: Back From the Economic Brink



Source: BEA

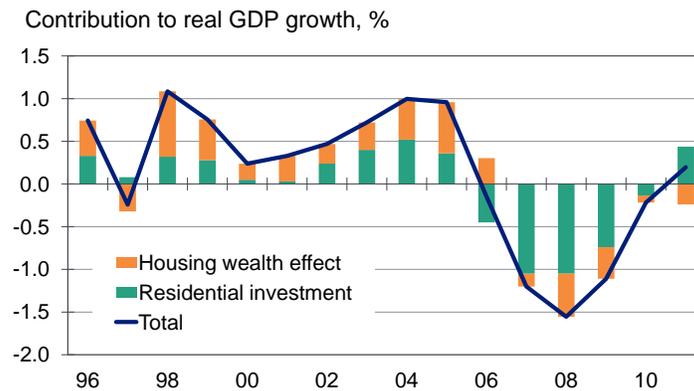
Behind this relative optimism is the financial health of U.S. businesses. Corporate profits are high and growing strongly, and business balance sheets are about as good as they have ever been. Larger businesses are doing much better than smaller businesses, but it is no longer a question of whether businesses can invest and hire more aggressively, it is a question of their willingness. With the nightmare of the Great Recession fading and the policy uncertainty that has been weighing on the collective business psyche abating, businesses are expected to soon become more willing.

The economic wrongs that were at the heart of the financial panic and recession are being righted. The five-year-long crash in the housing market is winding down. With better job growth, near-record housing affordability, and ample credit from Fannie Mae, Freddie Mac and the FHA, housing demand should slowly revive. Barring further serious fallout from foreclosure processing problems, investor demand for distressed properties should be sturdy. House prices have fallen enough for investors to see opportunities in fixing and renting these houses.

Home construction will also slowly rebound to replenish the inventories of new homes, which have never before been this lean. Overbuilding during the bubble left the market glutted, but this excess inventory is being worked off despite depressed demand, because new construction is even weaker. The glut is concentrated in Florida, Atlanta, Nevada, Arizona and the Central Valley of California. In most other parts of the nation, inventories will return near historically normal levels next year.

Housing's historic drag on the broader economy is thus expected to fade this year. The anticipated increase in new construction will offset house price declines and resulting negative wealth effects as homeowners save more and spend less (see Chart 2). This is a big swing since the depths of the recession, when housing was subtracting a couple of percentage points from annual real GDP growth.

Chart 2: Housing Hits Bottom in 2011



Households are rapidly reducing their debt loads and are paying on their debts in a more timely way. Delinquency rates are falling rapidly across all types of loans, from credit cards and auto loans to even first mortgage loans. Financial institutions are benefiting from the improved loan quality and, with their higher levels of capital, are increasingly willing to lend. Credit remains tight, but the spigot is beginning to open for an increasing number of households and businesses.

The economic recovery is also being supported by continued aggressive monetary and fiscal policies. The Federal Reserve has shown no indication that it will end its zero interest rate policy any time soon, and its quantitative easing efforts are keeping long-term interest rates lower and stock prices higher than they would be otherwise. The political compromise reached at the end of last year to temporarily provide additional tax breaks and emergency unemployment insurance is also instrumental in ensuring that the economic recovery evolves into a self-sustaining expansion this year.

Despite the optimism, there are still considerable threats to this hopeful economic script. Severe budget cutting and tax increases by state and local governments, needed to fill their gaping budget holes, will be a significant impediment to the job market and broader economy. Europe's efforts to solve its debt problems or China's attempt at a soft landing could go astray and derail the anticipated U.S. recovery. The recent political turmoil and social unrest in Egypt, Tunisia, and other parts of the Middle East underscore the near-constant danger to our economy from higher global oil prices.

A mounting threat is posed by the nation's large budget deficits, rapidly rising debt load, and the fact that, without significant fiscal policy changes, global investors will soon balk at buying our debt at low interest rates. Prospects for a bruising political battle over an increase in the debt ceiling limit later this spring or summer also pose a substantial concern. Global investors are already anxious regarding our ability to come to a political consensus to address the nation's fiscal challenges; a protracted debate over the debt ceiling would be very counterproductive.

Moreover, with millions of foreclosures still in the pipeline, my optimism that the housing crash may soon be over could be upended. Indeed, more distress sales and house price declines are coming, and—given that the home is still the most important asset most households own and that many small-business owners use their homes as collateral to get loans to expand their operations and hire—it is hard to get

overly enthusiastic about the recovery's prospects. It is appropriate to be concerned that the vicious cycle of more foreclosures begetting more price declines begetting more underwater homeowners and more foreclosures could be reignited.

It is also important to consider that under the best of circumstances, unemployment will remain painfully high and households' nest eggs will remain significantly diminished for a number of years. Thus, while it is improving, sentiment remains extraordinarily fragile, and it would not take much of a hit to undermine it. The proverbial economic coast is thus not yet clear. Policymakers should provide aggressive support to the economy until it is unambiguous that the forecasts of stronger economic growth and falling unemployment have definitively come to fruition.

This testimony will consider the shape of the U.S. economic recovery, the challenges that remain to the recovery, and focus specifically on what further steps policymakers might want to consider in regard to the threat posed by the ongoing problems in the housing market and foreclosure crisis.

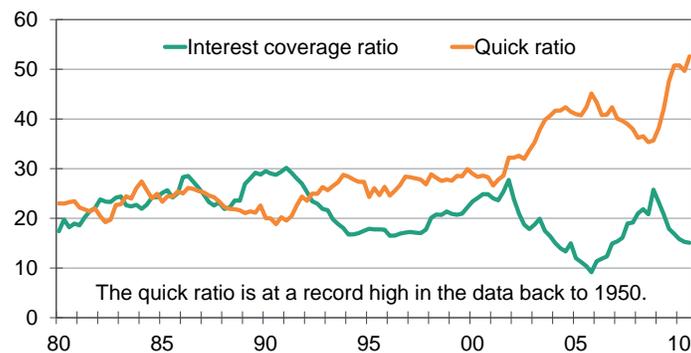
Healthy corporations

Surging corporate profits and increasingly sturdy corporate balance sheets will form arguably the most powerful boost to the economy, persuading businesses to finally boost investment and hiring. Earnings have fully recovered from the recession, after firms dramatically lowered costs and widened profit margins. This is particularly impressive given generally weak pricing and only modest sales gains. Earnings growth among both large, publicly traded companies and small, privately held firms has rarely been stronger; it is now expanding at a yearly rate of more than 25%. Such comparisons are still easy given the downdraft in earnings during the recession, but the profit gains enjoyed during this recovery are among the strongest recorded since World War II.

Business balance sheets are also about as strong as they can be. Corporations have deleveraged amid low borrowing costs; thus, the interest coverage ratio—the proportion of cash flow going to debt payment—has fallen significantly. Under reasonable assumptions regarding future borrowing, interest rates and cash flow, it will approach a record low by this time next year. Cash holdings have also surged, and in proportion to short-term corporate liabilities, they have never been higher (see Chart 3).¹ Balance sheet strength is evident in nearly every industry.

Chart 3: Solid Business Balance Sheets

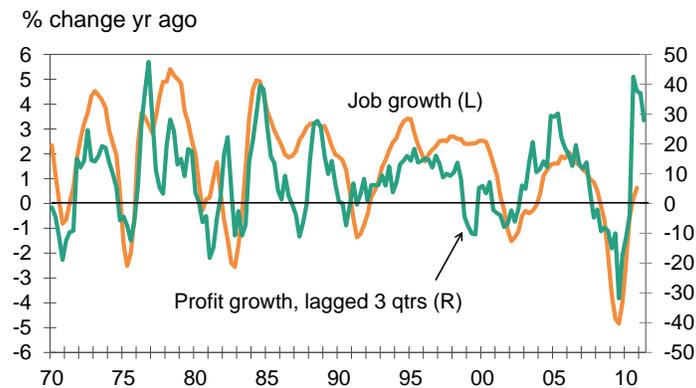
Nonfinancial corporate businesses



Sources: Federal Reserve, Moody's Analytics

There is no longer any doubt about businesses' ability to expand; the only question is when they will be willing to do so. If history is a guide, this should begin over the next few months. In past recoveries, profits improved six to 12 months before job growth picked up (see Chart 4). The logic is straightforward: Managers realize they cannot boost profits forever merely by cutting costs. To sustain strong earnings growth and to support their stock prices, they need to seek revenue opportunities. That means greater investment and more hiring.

Chart 4: Profits Surge, and Jobs Should Follow



Sources: BLS, BEA

The process has been more attenuated in the current recovery, probably because of credit constraints on smaller businesses and the psychological battering all firms have taken. Many managers still seem shell-shocked from their near-death experiences during the Great Recession. Businesses have also been unnerved by the epic policy changes of the past year, affecting healthcare, financial regulation, and the tax code. Debates have raged as well around the cap-and-trade plan to curb carbon emissions, immigration reform, and organized labor's "card check" proposal, none of which resulted in legislation. Still, each came close enough to worry business managers.

The collective business psyche should slowly improve, however, as the credit spigot reopens for small businesses and the next Congress blocks further major economic policy changes. Better business sentiment combined with strong profits and sturdy balance sheets should make for a better year.

Deleveraging winds down

With weak asset prices and high unemployment, households have been under extraordinary pressure to reduce their debts. This deleveraging has been a powerful drag on consumer spending but should begin to wind down later this year. As the pace of debt reduction slows, consumer spending and thus broader economic growth will gain traction.

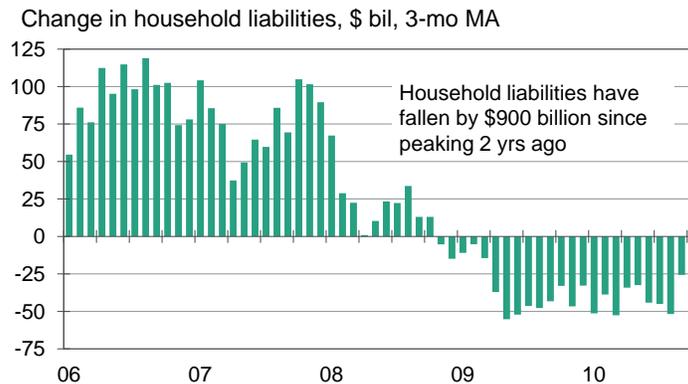
Key to consumer spending growth is the pace of household borrowing. Consumer spending is powered by household cash flow, which equals the sum of income, realized capital gains, and net borrowing. The growth rate of consumer spending thus equals the rate of income growth, the change in realized capital gains, and the change in net borrowing.

During the housing boom and bubble, households borrowed aggressively, pulling an unprecedented amount of cash from their homes via home-equity borrowing and cash-out refinancing. At the peak of the equity withdrawal in the summer 2006, homeowners were extracting almost 9% of their disposable income in cash from their homes. This compares with about 3% at the start of the decade.ⁱⁱ

With the housing crash, homeowners are no longer taking equity out of their homes, and some higher-income households are likely repaying their mortgages more quickly. With deposit rates near zero and returns on other investments uncertain, homeowners could be opting for the sure, if low, return of lowering their mortgage debt.ⁱⁱⁱ Supporting this scenario is a relatively high share of recent refinancing deals that involve switching from 30-year mortgages to 15- or even 10-year mortgages.

Even more striking is a reduction in credit card borrowing. According to Equifax, more than 100 million fewer bank cards are in use today than in the summer of 2008, a 25% decline.^{iv} With mortgage and card debt falling rapidly, total household liabilities are declining at an unprecedented rate of almost \$500 billion annually (see Chart 5).^v

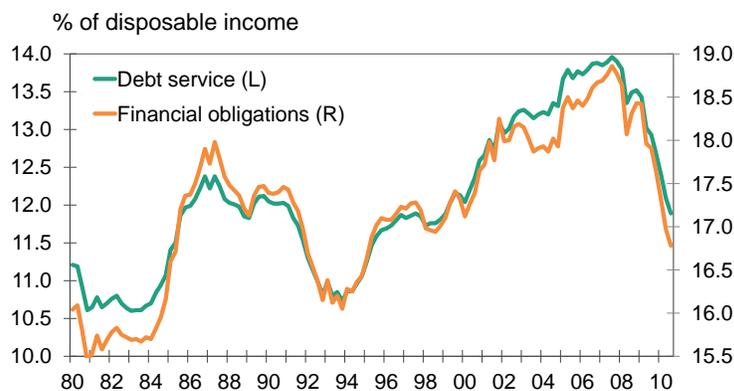
Chart 5: Deleveraging Is Well Under Way...



Sources: Equifax, Moody's Analytics

Deleveraging is thus at its apex and expected to slow in the coming year. Key to this view is the plunge in household debt burdens—the share of after-tax income that households must devote to servicing debt to remain current. Falling debt outstanding combined with record low interest rates, and better income gains have pushed the debt service burden down by more than 2 percentage points since it peaked two years ago (see Chart 6). The debt burden has already fallen below its long-run average and will approach a record low by this time next year, even under conservative assumptions regarding further deleveraging, interest rates and income growth.^{vi}

Chart 6: ...Pulling Debt Burdens Lower



Sources: Federal Reserve, BEA, Moody's Analytics

Households are less focused on how much they owe, and more on how much of their cash goes to paying that debt. With debt service burdens easing, households will relax a bit. They will not be releveraging anytime soon, but simply not deleveraging means they will be spending more freely before long.

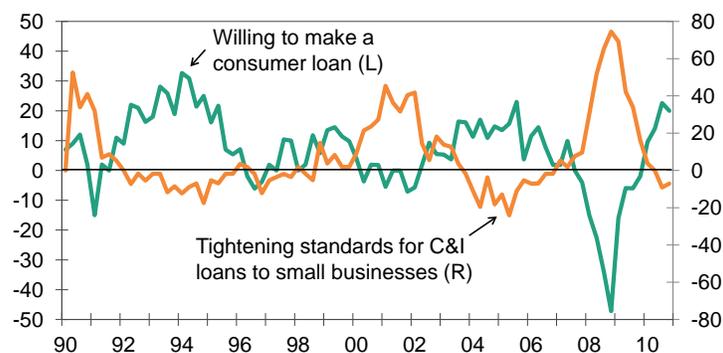
Credit spigot opens

Tight credit has been strangling the economy, but this too will ease in the coming months. Creditors will be persuaded to loosen the credit spigot by improving credit quality and by the financial system's return to profitability. More credit will fuel more spending and investment, particularly by small and midsize companies.

Credit dried up during the financial crisis and Great Recession. Even the highly liquid commercial paper market—a vital source of funding for the bluest-chip multinational corporations—would have turned dry without help from the Federal Reserve at the height of the panic. Lenders to households and smaller businesses all but shut down. The net percentage of senior bank loan officers willing to lend to consumers reached its lowest level since the 1970s, when the Carter administration temporarily imposed credit controls in an attempt to stem inflation. Nearly all loan officers said they were tightening criteria for commercial and industrial loans. (see Chart 7).

Chart 7: The Credit Spigot Is Opening

Net % of senior loan officers...



Source: Federal Reserve Senior Loan Officer Survey

Credit conditions have eased a bit already. The percentage of loan officers willing to lend to consumers is back to levels seen in better times. Lenders are also easing standards for C&I lending, and although standards remain tight, they should loosen soon.^{vii}

The conditions necessary for a much more substantial easing in lending standards and better credit flows are largely in place. A large number of first mortgage loans are still in the foreclosure process or likely headed there, but otherwise credit quality is good and improving rapidly. As of October, fewer than 12 million loans (not including first mortgages) were between 30 and 90 days delinquent.^{viii} This is down from more than 17 million in early 2009, and the smallest number since the early 1990s. Even early-stage first mortgage delinquency is improving, with 1.7 million loans 30 to 90 days delinquent, down from more than 2.1 million at the peak.

Improving loan quality, wide net-interest margins, and improving investment banking revenue are propelling better bank profits. Commercial banks' returns on assets are still well below their prerecession levels, but have come back strongly from the recession. Big banks are doing particularly well, after the rigorous stress tests in the spring of 2009 that forced institutions to add sufficient capital to insulate against a potential economic depression. While the recession was extraordinarily severe, it was not nearly as bad as

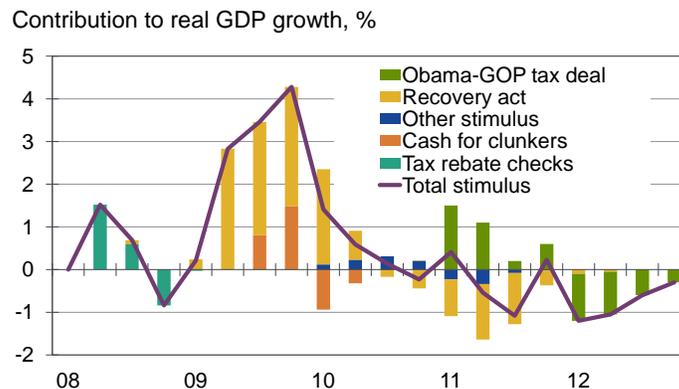
envisaged by the stress tests; these institutions are now arguably overcapitalized, at least in aggregate. Many small banks have not been able to raise capital and are still struggling with troubled commercial real estate mortgage and construction loans, but they account for only a very small part of banking system assets.

Lending is already showing signs of turning up. New originations for credit cards, auto loans, and consumer finance loans are above year-ago levels for the first time since 2007. This is even the case for borrowers with lower credit scores. The size of credit lines is also growing. Most encouraging is that C&I loans outstanding have finally turned the corner. This is one of the best lagging indicators of the business cycle, historically providing positive proof that the downturn is ending.

More policy support

The December compromise between the Obama administration and congressional Republicans on taxes and government spending adds significantly to growth prospects in 2011. The size and scope of the deal were a surprise; as a result, while fiscal policy still will add little to growth next year, at least it will not create much drag (see Chart 8). The agreement will add approximately a percentage point to real GDP growth in 2011, double expected job growth from 1.3 million to 2.6 million, and reduce unemployment by about a percentage point. Instead of hovering near 10% throughout the year, the jobless rate will fall below 9% by year's end.

Chart 8: Fiscal Stimulus a More Modest Drag



Source: Moody's Analytics

Even without the tax deal, the economy would probably have made it through 2011 without falling back into recession, but this compromise improves those odds significantly. It also reduces pressure on the Federal Reserve to engage in more aggressive quantitative easing, which even its most ardent supporters did not expect to substantially boost growth. Quantitative easing has complicated the Fed's dealings with other global central banks, by helping to push up the exchange value of their currencies against the U.S. dollar. It also has inflamed Republican legislators, who claim it will unleash high inflation, or that it constitutes fiscal policy that is outside the Fed's mandate.

There are some downsides to the tax deal. Congress will make little progress toward reducing the budget deficit in the current fiscal year. The deficit appears set to come in near \$1.3 trillion in fiscal 2011, equal to 9% of GDP, about the same as in fiscal 2010. While the impact on long-term interest rates should be limited, there is a risk of backlash by global investors rightly nervous about the U.S. fiscal outlook.

It is also important to note that U.S. economic growth will be lower in 2012 than previously anticipated, as the fiscal drag expected in 2011 is pushed off a year. The economy will end in about the same place by mid-2013 as measured by GDP, jobs, and unemployment. The compromise of tax and

spending policies could have also been better designed to maximize economic efficacy. The deal includes a range of tax cuts for households and businesses, some of which pack little bang for the buck.

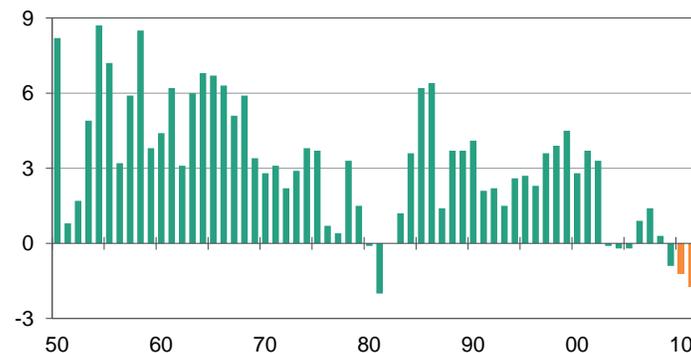
Local government meltdown

While there are good reasons to be optimistic about the recovery's prospects, the economy is still fragile and many things could still go wrong. Of particular note is that state and local governments are scrambling to close prodigious budget holes. This is despite stiff budget cutting in 2010, which included a quarter-million job cuts, big program reductions, and tax increases. These steps have been necessary even with the \$175 billion in increased federal grants-in-aid that states are due to receive as part of the fiscal stimulus.^{ix}

Without additional help from Washington, which seems unlikely, federal aid will dry up at the end of the current fiscal year, in June for most states. Nominal state and local government spending will have to remain flat for the remainder of this fiscal year and next if states are to balance their budgets, even assuming tax revenue growth of 6%.^x This suggests declines in real state and local government spending of almost 2% in calendar year 2011; since World War II, only the 1980 recession year was harder on state and local government budgets (see Chart 9). Accounting for these spending cuts and tax increases and their economic multipliers, state and local governments will be responsible for shaving approximately 0.4 percentage points from real GDP growth in 2011.

Chart 9: State and Local Government Retrench

Growth in real state and local government spending, %



Sources: BEA, Moody's Analytics

This anticipated state and local government drag on growth is serious, but manageable. A string of sizable municipal bond defaults would be unmanageable. Investors are nervously considering this prospect. Muni credit default swap spreads—a measure of the cost of purchasing insurance against a municipal government default—and interest rate spreads between munis and Treasuries are much wider than historical norms.

Odds that a state would default on its debt obligations are remote. The biggest and most hard-pressed states, including California and New York, have graduated income tax systems that produce significant revenue when the economy improves, as it should this year.^{xi} States also have low debt loads, and their interest payments account for only a small percentage of their cash flow.

The odds that local governments might default are much higher. While there have been a handful of recent small, local defaults due to mismanagement or fraud, it is not hard to construct scenarios in which defaults spread, given weaker house prices, falling property tax revenues, and mounting pension obligations. It is also not inconceivable that such a wave of defaults could reignite turmoil in financial markets and derail the economy.

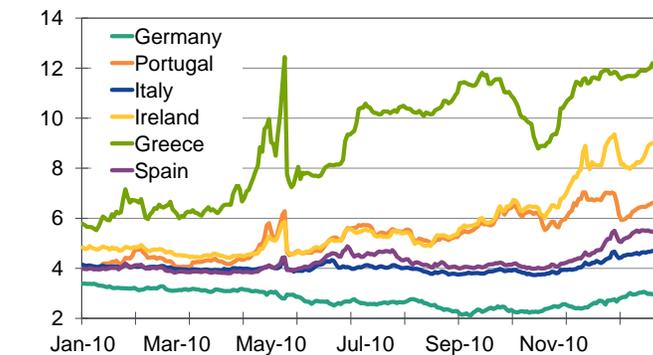
European debt crisis

Another serious worry is the European debt crisis, which has yet to be brought under control. Greece and Ireland have been forced to borrow from a \$1 trillion bailout fund established by the European Union and International Monetary Fund, and it appears inevitable that Portugal will have to follow them soon.^{xii}

Investors also have questioned Spain's fiscal viability, pushing up yields on that country's sovereign bonds sharply. Ten-year Spanish sovereign bond yields are just under 6%; if rates rise much above this, Spain's debt-servicing costs will be overwhelming (see Chart 10). Rescuing Spain would likely exhaust the bailout fund. Prospects of this are making global investors increasingly edgy, further driving up interest rates in what could become a vicious cycle.

Chart 10: Debt Problems Threaten to Boil Over

10-yr sovereign yields, %



Sources: Bloomberg, Moody's Analytics

To break this cycle, European policymakers—and, more specifically, German and French officials—need to do more. A bailout fund closer to \$1.5 trillion is necessary to convince investors they will get back all the money they have invested in European sovereign debt. This may be too much of a financial strain for Europe to credibly handle on its own; thus the IMF may have to ante up more.

The European Central Bank will also have to step up its purchases of troubled sovereign debt. To date, the ECB has purchased close to \$100 billion in Greek, Irish and Portuguese bonds, which have kept yields, and thus borrowing costs, down for these nations, but clearly not sufficiently. The ECB may also have to soon purchase the debt of other national governments, including Spain. This will weaken the ECB's balance sheet, but it would be better for the ECB to try to manage this debt than for the fragile European banks and other financial institutions that are now choking on it. The ECB may also have to end its policy of sterilizing bond purchases, although given its criticism of the Federal Reserve's quantitative easing policy, it is likely to do so only under severe duress.

European banks must also be put through substantive stress tests, with transparent results that require the banking system to raise significant new capital. Europe's stress tests last summer were opaque, and little capital was raised. It is clear that the process was woefully inadequate, given that the Irish banking system was all but nationalized just a few months later. Compare this with the U.S. bank stress tests completed in spring 2009, which forced big banks to envision a depression scenario and build capital accordingly. The depression never came, and the U.S. banking system is now well capitalized.

The longer European policymakers resist these steps, the greater the odds that financial turmoil will grow and that the European economy will suffer a double-dip recession, all of which would reverberate on the U.S.

Chinese hard-landing

U.S. growth prospects also depend on a relatively soft landing in key emerging economies, particularly China, where policymakers are working hard to avoid overheating. The Chinese economy was the first to recover from the global recession, and, due in large part to aggressive use of the monetary and fiscal stimulus, its subsequent recovery has been vigorous. China's economy is now operating near or above its capacity, as evidenced by sharply accelerating Chinese inflation (see Chart 11). There is also on-again, off-again nervousness about speculation in the property and equity markets.

Chart 11: China Threatens to Overheat

Chinese consumer price inflation, % change yr ago



Source: National Bureau of Statistics China

Chinese authorities have responded by raising bank reserve requirements, tightening lending standards, and raising interest rates. They also resumed a policy of gradual currency appreciation, letting the yuan rise more than 3% against the dollar since then. Faster appreciation is warranted, since it seems to be the most effective way to both address China's domestic economic challenges and quiet the complaints of its trading partners such as the U.S. Chinese authorities do not see it that way, however, remaining concerned about the impact of faster currency appreciation on their export-oriented economy.

Other emerging economies have allowed market forces to push up their currencies' values more quickly, with benign effects so far. Chile, India, Indonesia and Turkey are good examples of nations successfully following this policy approach. But this has not convinced the Chinese.

While China will likely pull off a soft landing despite its currency policy, it might not be as graceful as hoped. A hard landing seems unlikely, given the country's massive international reserves, which could be used to finance another huge dose of fiscal stimulus, but even a bumpy landing could cause significant problems. Many commodity-producing emerging economies would struggle, given the likely drop in global commodity prices—Chinese demand for everything from oil to copper and soybeans is pushing prices higher. Developed economies, including the U.S., would also suffer, given how important the emerging world has become as an export market and the fallout this would have on global equity markets.

Foreclosure crisis

Ground zero for the financial panic and Great Recession was the housing crash. Since the real estate bubble burst nearly five years ago, residential construction has fallen to pre- World War II levels, house prices have plunged more than 30%, and nearly 5 million households have lost homes through foreclosure or short sales.^{xiii} While there are good reasons to believe that the housing market will bottom out this year, there are also good reasons to be nervous that the crash will continue. Most worrisome is the ongoing foreclosure crisis and prospects for more house price declines.

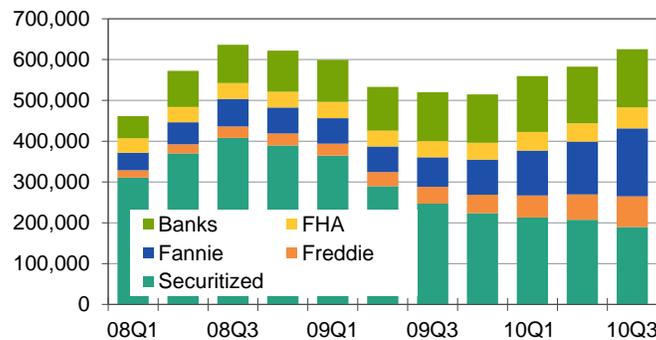
With more than 4 million first mortgage loans in the foreclosure process or likely to default, distressed properties will account for an increasing proportion of total home sales in coming months.^{xiv} Loan modification efforts, including the government’s HAMP plan and private plans, will be helpful in reducing the number of distress sales, but even so, the share of such sales will rise and house prices will fall.^{xv}

The same vicious cycle that plagued the economy during the recession threatens to be reignited, with house price declines pushing more homeowners underwater and precipitating more defaults, which drive prices lower still. An estimated 14 million homeowners are already underwater, with far more than half owing more than 20% above their homes’ market values.^{xvi} Beyond this threshold, many more homeowners decide strategically to default rather than continue to make mortgage payments with little prospect of ever rebuilding equity.

The number of repossessed properties classed as “real-estate owned” by banks, the last stage before they are resold, is also rising, even though they had already reached levels similar to those seen in late 2008, when house prices were plunging (see Chart 12). Mortgage owners appear increasingly interested in pushing distressed loans into foreclosure and resale, regardless of the prices they are receiving. This is a big change from a year ago, when mortgage owners were slowing foreclosures because of uncertainty regarding the amount of capital they would need to digest their credit problems.

Chart 12: REO Inventory Is Building Again

REO inventory



Sources: Fannie, Freddie, FHA, Moody's

Nothing works well in the economy when house prices are falling; the home remains the most important asset for most households and a key source of collateral for many small businesses seeking credit. The fallout on the financial system and broader economy could be serious if house prices decline much more.

Housing policy proposals

Policymakers can take a number of steps to further mitigate the severity of the foreclosure crisis and the serious threat this poses to the housing market and economic recovery. These policy steps include:

- 1) *Revitalize the HARP refinancing program, which allows Fannie Mae and Freddie Mac to refinance underwater mortgage loans that they own and insure.*^{xvii}

With mortgage rates near record lows, millions of American homeowners could save money by refinancing their home loans. Such savings would not only give individual households a little extra to spend each month after meeting their financial obligations, but it could also offer the struggling U.S. economy a quick boost.

One reason homeowners are not doing so is that mortgage lenders are withholding their best interest rates from potential refinancers whose credit scores and home equity have eroded, even if their mortgage payments are current. Fannie Mae and Freddie Mac—the huge mortgage finance institutions that failed in 2008 and now are wards of the federal government—appear to be emulating the private lenders. This is significant, because Fannie and Freddie own and insure about half the nation’s outstanding mortgage loans.

Jump-starting HARP could be straightforward: simply require Fannie and Freddie not to charge add-on rates, even for refinancing borrowers who have lost a lot of equity or have relatively low credit scores. Keep in mind that Fannie and Freddie already bear the credit risk on these loans; anything that makes it easier for borrowers to pay their mortgages on time and avoid default will reduce the agencies’ ultimate cost.

Even borrowers in an early stage of delinquency may benefit from a HARP refinancing, although many of them likely have other financial problems that make loan modification or some other foreclosure mitigation the more prudent choice. But refinancing may help. Under current rules, borrowers who refinance under HARP are then ineligible for loan modification through the government. This restriction should be eliminated.

- 2) *Change the foreclosure process to include a third-party review prior to foreclosure, end the dual track that continues foreclosure while loan modifications are under way, provide homeowners with a single point of access when pursuing loan modifications, and establish a fund financed by the mortgage industry to compensate homeowners treated improperly in the foreclosure process.*

The loan modification and foreclosure processes have worked very poorly throughout the housing crash. Mortgage servicers have been inadequately staffed to address the massive number of loan problems, significantly delaying the process and resulting in serious errors. The affidavit-signing scandals have been only the most recent example of these problems. The implementation of a wide range of government-designed programs to help facilitate loan modifications, refinancings and short sales has not gone well because of their extraordinary complexity, the fact that they have changed a number of times, and the inadequate resources devoted by the mortgage servicers. Many distressed homeowners have been very frustrated and poorly treated by the mix-ups and mistakes.

To address these process problems, a third-party review system should be established to help homeowners navigate the loan modification and foreclosure process. An independent reviewer would help distressed homeowners determine the various options open to them and to work with their servicer to ensure that the process is working properly. This would also help ensure that the homeowners’ legal rights are being respected.

Mortgage servicers should also be required to end the practice of dual-tracking homeowners: considering their loan for a modification while at the same time moving forward with a foreclosure. This has created significant confusion, as homeowners negotiating a loan modification with a servicer have also received foreclosure notices. At times it appears that different departments within the same financial institution have been working at cross purposes. All loans should be considered for a modification first, and the foreclosure process should remain on hold until it is certain that a modification will not work.

Homeowners have also had significant difficulty in communicating with mortgage servicers. Homeowners are often confused over what documents and other information they are required to provide servicers, and these documents are often lost and must be sent multiple times. To address this problem, mortgage servicers should be required to provide homeowners with one point of contact in their organization who is responsible for shepherding the homeowner through the modification and foreclosure process.

FDIC Chairwoman Sheila Bair has also proposed establishing a fund financed by the mortgage industry to compensate homeowners who have been wronged by the foreclosure and modification process.^{xviii} This will provide a stronger incentive to the industry to make sure the process is working properly and fairly.

3) *Expand the FHA short refinancing program to include delinquent mortgage loans and loans owned and insured by Fannie Mae and Freddie Mac.*

Loan modifications that include some form of principal write-down have been shown to be particularly effective in keeping homeowners in their homes. To date, the numbers of these kind of modifications have been very limited. Policymakers have devised programs to provide incentives to mortgage servicers and mortgage owners to engage in such modifications, but so far they have not proved successful.

A more recent such program is the FHA short refinance program. It is designed for borrowers who are current on their loans and owe more than their properties are worth. Borrowers must meet all FHA underwriting guidelines. Loans already backed by the FHA cannot participate. Fannie and Freddie are not participating (though they have their own programs, including HARP).

If a borrower owes more than the property is worth, the lender and servicer must agree to reduce the loan balance by at least 10% so that the new loan is no more than 97.75% of the home's current value. If they are willing to take the loss, the borrower must agree to refinance into an FHA-backed loan at the current interest rate.

If the borrower holds a second mortgage, the combined loan-to-value ratio must be less than 115%. The second-lien holder must agree to the refinance, and if the combined LTV exceeds 115%, either the first- or second-lien holder (or both) will need to reduce the loan balance further. The government will make some incentive payments for second-lien holders that reduce principal.

While still early, the program has not gotten off to a very good start. This could be addressed by expanding the program to include loans that are delinquent. Mortgage owners are reluctant to engage in modifications that involve a reduction in principal unless the homeowner is unable to make the mortgage payments. In most cases, this is not clear until the homeowner is in delinquency. Allowing delinquent loans to be considered for the program may allow for more such modifications.

4) *Begin the arduous reform of the nation's mortgage finance system.*

Washington is gearing up for its next epic policy debate: what to do about Fannie Mae and Freddie Mac. The federal government created the two mortgage behemoths decades ago and then took them over as the financial system unraveled in 2008. What policymakers decide will determine how high mortgage rates go in the future, how easy it will be to obtain a home loan, and whether the popular 30-year fixed-rate mortgage continues to exist.

No one wants to return to the situation that existed just before the financial crisis. Fannie and Freddie had evolved into odd combinations of public and private; profit-maximizing, shareholder-owned companies with unique charters and implicit—but never clearly spelled out—federal backing. Each could thus borrow more cheaply than other financial institutions could, and both used that advantage to earn rich profits investing in higher-yielding mortgages. Fannie and Freddie were also allowed to operate with very thin capital cushions to protect them if their investments went bad.

There was a political quid pro quo for these advantages: Fannie and Freddie had to give a significant share of their mortgage loans to lower-income homeowners and members of disadvantaged groups. It was not a bad goal, although it was probably taken too far, and the nation clearly paid a high price for it. Of all the federal government's bailouts during the financial panic, those of Fannie and Freddie will cost taxpayers the most—almost \$150 billion. Rescuing Detroit's automakers, by comparison, cost about \$15 billion, while the bank bailouts actually resulted in a net gain for taxpayers.

One solution to the Fannie and Freddie problem is to formally and permanently make them part of the federal government. The chief benefit: a guaranteed steady flow of credit, at reasonable rates, in both good and bad economic times.

But nationalizing Fannie and Freddie would saddle the government with significant new risks, as well as with the institutions' debts, which would add to an already-mountainous federal debt load. In the long run, such a system could also stifle innovation, while tempting lawmakers to subsidize mortgages for favored constituents, distorting a huge part of the U.S. economy.

Another solution would be to take the opposite approach—that is, full privatization. Allow no government backstop for the mortgage market, either implicit or explicit. Government might retain a small role, but Fannie's and Freddie's operations would be spun out to the private market.

A privatized system would give all parties more incentive to be prudent. Mortgage originators, issuers of mortgage-backed securities, rating agencies, and investors would all suffer if they made bad decisions. Nobody would be too big to fail, and taxpayers would be off the hook—at least in theory.

But full privatization probably works better in theory than it would in practice. Whatever legislators pledged never to do, global investors assume the U.S. government would rescue the housing market in a crisis. Meanwhile, a privatized mortgage finance system would significantly raise costs for borrowers and would be a much less reliable source of credit.

Privatization would also endanger the 30-year fixed-rate mortgage, a bedrock of home lending since the Great Depression. Such loans are practically unique to America; nearly everywhere else, homeowners can obtain only adjustable-rate mortgages, with monthly payments fixed only for specified short periods. But because they are risky for banks and difficult to manage, long-term fixed-rate mortgages will almost certainly disappear without some form of continuing federal support.

Fortunately, there is a middle way between nationalization and privatization. A hybrid mortgage finance system would allow private institutions and the federal government to share the risks. Such a system holds the most promise for delivering consistent, affordable mortgage loans on prudent terms to borrowers, with minimal costs to taxpayers.

In a hybrid system, some of Fannie's and Freddie's operations would be turned over to the private market, while others would be transferred to the government. Instead of the market-distorting implicit government support for Fannie and Freddie, the government would offer insurance at an explicit price. The hidden cost of Fannie's and Freddie's subsidies to homeowners would also be made visible on the government's books. Private institutions would provide the bulk of the system's capital and would also originate and own the mortgages. The federal government would insure the system against catastrophe, regulate it, and clearly spell out whatever subsidies are given to low-income families or others.

A hybrid system would preserve the benefits of both nationalization and full privatization. Investors would remain on the hook for most losses, keeping incentives in place for prudent lending and risk pricing. The government's involvement, however, would keep mortgage rates lower and help credit flow freely, especially during difficult times.

Decisions made in coming months about the future of Fannie and Freddie will affect homeowners and the economy for decades. Success will depend on striking the appropriate balance between the benefits of the private market and the backstop of the federal government. Finding the right balance will result in a stronger housing market, a more stable financial system, and a healthier economy.

Conclusions

After three lean years of recession and weak recovery, the coming year is shaping up to be much better for the U.S. economy. The wrongs that undermined the financial system and economy are slowly being righted; households are deleveraging, banks are recapitalizing, and government budget gaps, while still yawning, are finally narrowing. It will take years to work through all the mistakes that generated the financial panic and Great Recession and even longer to pay for cleaning it up, but clear progress is being made.

U.S. businesses are also in excellent financial shape. Big and midsize firms in particular are highly profitable, and their balance sheets could not be much better. Corporate executives have been reluctant to invest and hire more aggressively, but that seems set to change soon. The nightmare of the Great Recession will not be forgotten for a generation or two, but its psychological sting is fading. The policy uncertainty that may have frozen corporate decision-making will also abate, as no major new policy initiatives seem likely soon. Unless businesses begin to expand, they will be hard-pressed to maintain earnings growth that is acceptable to their shareholders.

There are substantive threats to this optimism. It is hard to get too excited as long as house prices keep falling, which seems inevitable, given the bulge of properties in the foreclosure pipeline moving toward distress sales. The tough budget and tax decisions being made in state and local government offices across the country will be a major drag, dampening enthusiasm. Europe's efforts to solve its debt woes and China's attempt at a soft landing may also not stick to script. Moreover, even under the best of circumstances, unemployment will remain painfully high, and Americans' nest eggs will be much smaller than before the crisis.

Still, while the economy is not guaranteed to meet our optimistic expectations, these increasingly seem a good bet, particularly if policymakers remain aggressive in supporting the economy until it is clear that it is off and running.

ⁱ This is based on the Federal Reserve's Flow of Funds data. Short-term corporate liabilities include all liabilities that come due within one year.

ⁱⁱ California homeowners were the most profligate, taking out equity closer to a fifth of income at the peak; Central Valley homeowners withdrew almost a third of their income. These are Moody's Analytics estimates based on data from the Federal Reserve and Equifax.

ⁱⁱⁱ For the average homeowner, the after-tax rate on a mortgage is just above 5%.

^{iv} The number of bankcards outstanding has collapsed from a peak of 435 million in the summer of 2008 to 327 million currently.

^v This is despite steady growth in student loans outstanding and a recent increase in auto debt.

^{vi} The financial obligation ratio—a broader measure of obligations which also includes rent, property taxes, homeowners' insurance and lease payments—tells a similar story.

^{vii} The Federal Reserve's quarterly survey asks senior loan officers whether they have eased or tightened underwriting since the last quarter. In recent surveys, more officers have reported easing than tightening after several years of substantial movement in the other direction. This suggests standards are easing, even if they remain tight by historical standards.

^{viii} This is based on seasonally adjusted Equifax credit file data. Lower delinquency is also reflected in improving average credit scores.

^{ix} The increased federal grants-in-aid have taken many forms, including additional monies for Medicaid, educational and unemployment insurance expenses, and infrastructure spending.

^x State and local tax revenue growth has been more or less consistent with nominal GDP growth over the past 40 years. Tax revenue growth is expected to be somewhat stronger than nominal GDP growth in 2011 and 2012 due to some further modest tax increases.

^{xi} The troubled state of Illinois and its low flat income tax is a notable exception.

^{xii} The European Financial Stability Fund (EFSF) established in May 2010 by all 27 member states of the European Union and IMF, can issue debt to provide loans to euro zone countries in financial trouble.

^{xiii} This is based on the Fiserv Case-Shiller national house price index. This index includes distress sales, which are generally sold at a large discount to nondistress sales. The Moody's Analytics estimate of lost homes is based on Equifax, RealtyTrac and Realtors data.

^{xiv} According to Equifax credit file data, there are just over 51 million first mortgage loans outstanding.

^{xv} There will be approximately 1.75 million first mortgage loan modifications in 2010, including about 500,000 HAMP modifications and 1.25 million private modifications.

^{xvi} The estimate of 14 million negative-equity homeowners is based on Equifax credit file and Case-Shiller house price data and is measurably greater than the commonly used estimate from Core Logic of closer to 11 million. The Moody's Analytics estimate of negative-equity homeowners is nearly the same as Core Logic's in California, much lower in Florida, and higher most everywhere else. A possible explanation for the difference is the difficulty Core Logic may have in measuring mortgage debt in rural areas, where homeowners generally see little equity appreciation even in good times (as house prices never rise much) and assume small negative equity positions in difficult times. The Moody's Analytics estimates are much higher in Texas, for example. Core Logic also does not have data for a half-dozen small states.

^{xvii} See "Restraining HARP," Mark Zandi and Cris DeRitis, Moody's Analytics special report, October 10, 2010.

^{xviii} This idea was articulated in a January 19, 2011 speech to the Mortgage Bankers Association. See <http://www.fdic.gov/news/news/speeches/chairman/spjan1911.html>