

Lawrence H. Summers
Harvard University

Summary of Testimony

The Current Economic Situation

- I. The economy is very likely to be in a recession. If it is not in recession this is just a technicality. The dislocations typically associated with recessions are almost certain to be felt. The likelihood is very high that the downturn will continue for at least the next two quarters despite the many constructive steps including fiscal and monetary stimulus that have been taken in recent months.
- II. More distress lies ahead. Confident forecasts are impossible but available futures markets' estimates suggest that house prices could easily fall an additional 15% to 25% from current levels. Declines are likely to be concentrated in lower priced homes that have been financed through sub-prime mortgages and in areas of the country where sub-prime lending has been especially prevalent. It is conceivable that if the recession proves protracted or there are further serious problems in the financial system the decline in house prices could be considerably more severe.
- III. These declines in house prices are placing unprecedented burdens on the mortgage finance system. It appears that the dominant determinant of foreclosure experience is the behavior of home prices and not the financial fortunes of individual borrowers. It is likely that within the next 2 years up to 15 million homes will have negative equity and that more than 2 million foreclosures will take place. Because we are in unprecedented territory with respect to the pervasiveness of negative equity it is impossible to predict accurately how many people will walk away from their homes. I believe there is more room for foreclosures to surprise on the high than on the low side.
- IV. While there has been some restoration of normality in the financial markets since the Bear Stearns events of mid-March, markets remain quite fragile. In particular there is considerable reason to believe that some debt securities, including those backed by mortgages, are selling at prices that reflect scenarios considerably more dire than those set out above. In the judgment of most sophisticated market observers, this reflects financial conditions rather than a market judgment that house prices will fall even more catastrophically than the consensus envisions.

Policy Choices.

There is no legitimate basis given the magnitude of disruptions in the financial markets for complete confidence that the housing market will be self-correcting. There is the risk of vicious cycles as declining prices lead to foreclosures which lead to increased supply which lead to declining prices. There are also risks of vicious cycles of a similar kind in the mortgage market. Prudent public policy can make an important insurance for the housing sector and by supporting the housing sector, to overall economic health.

At the same time, it is essential to recognize that policies that serve only to delay inevitable adjustments can easily prove counterproductive. There will be no ultimate stability until market prices reach levels at which potential investors and homeowners feel good about their prospects. The policy challenge is to mitigate market overreactions while not interfering with necessary or inevitable adjustments.

Policy makers should give serious consideration to these five areas:

- I. GSE Policies: The GSE's have a potentially critical role at a time of cyclical disturbance to the housing finance system such that we are experiencing right now. It is important however to recognize that their viability is dependent on the government's implicit guaranty. A policy such as those suggested by some of simply allowing the GSE's to expand their balance sheets would provide support for the mortgage market and housing sector but it would do so in a highly problematic fashion because the burden on the Federal Treasury imposed by the implicit guarantee would increase and a significant part of the associated subsidy would flow to shareholders rather than to homeowners. It is essential therefore that the GSE's raise capital on a very substantial scale for both prudential reasons and to back expanded lending. While this may not be the first choice of their shareholders, it is essential to the national interest. No issue is more important for the housing sector than assuring that better capitalized GSEs are over the next year able to buy hundreds of billions of dollars more in mortgage product.
- II. There is a strong case for federal support for the writing down of mortgages in selected cases. It is clear that the foreclosure process is enormously costly both for the value of the home in question and the community in which it is embedded. Action to purchase and renegotiate mortgages that would otherwise force foreclosure can benefit both homeowners, the housing market, and the broader financial system. Careful consideration should be given to measures of the type that have been discussed by Senator Christopher Dodd and Congressman Barney Frank. In such consideration, it will be essential to ponder design issues including:
 - a. The treatment of second liens
 - b. The integrity of appraisals on which valuations are based
 - c. Possible adverse selection effects on mortgages offered by servicer's.
 - d. Eliminating incentives for opportunistic behavior by homeowners
- III. There are desirable changes in legal rules. Possible significant gains with almost no risks would come from relieving servicers of legal liability for decisions they make in renegotiating mortgages. Of even greater significance, proper bankruptcy reform would increase economic efficiency and equity. I believe it is very difficult to defend at a time like the present a bankruptcy code that provides more protection for the third home of a wealthy family than for the first home of a working family. Properly circumscribed bankruptcy reform could through its direct and indirect effects, facilitate a significant amount of private mortgage relief. I believe the concern that this would somehow inhibit the flow of new credit to owner occupied housing is often overdrawn and can be met through careful design.
- IV. Stimulus tax measures should be directed to families burdened by disruptions in the mortgage and housing markets. In this regard I am concerned by proposals contained in Senate legislation. Providing tax credits conditioned on initiation of the foreclosure process is likely to have perverse effects -- foreclosures may be encouraged and the benefits will flow to financial institutions that have foreclosed on homes rather than to families in need. Experience and economic logic suggests that tax benefits targeted to those with losses are likely to have minimal stimulative impacts. To the extent that stimulus and responding to economic distress are key objectives, tax measures targeted at those who suffer foreclosure or at the conversion of foreclosed homes into rental housing would represent a substantially more effective public policy choice.