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Comments on the Economic Crisis of 2007 Onwards

This is not an academic paper or journalistic paper. It is my comments on the economic crisis that began in 2007, what went before, and why it is not resolving very well. I give no evidence. If enough readers want evidence, and can convince me it is worthwhile, I will find evidence.

The crisis did not really begin in 2007. It had been building for several decades. Even after the Great Depression of the 1930s, we have had economic problems that we refuse to resolve, and those problems periodically contribute to a crisis. The business cycle creates problems about every ten years regardless of other forces. The present crisis, based on housing, began with large-scale federal intervention in the American housing market after Word War 2. Other events contributed throughout the decades such as the de-industrialization of America. I am not sure which contributor was strongest.

What Happened.

Briefly, Americans had nowhere else good to invest other than real estate, Americans needed a hedge against inflation, and real estate prices continued to climb faster than inflation, so Americans invested in real estate. Much the same happened to real estate as happened to gold after 2002. Investing in real estate was a good rational decision by individuals that led to a bad bubble collectively.

The housing bubble really began in the middle 1970s as America began to lose its dominance of the world economy. That was when housing prices first began to feed on themselves and to escalate rapidly. The bubble did not quickly develop crisis proportions because other forces masked the situation for a while, such as rampant inflation, the “Savings and Loan” debacle, the recession of 1990, the “dot com” bubble, the firs war in Iraq, the recession of 2000 and following, and the wars in Iraq and Afghanistan after 2002.

Americans did not have avenues for investment other than housing, housing prices continually escalated, middle class people sought to protect what investments they did have, business firms sought an avenue to invest their increasing profits, and wealthy people sought an avenue to invest their increasingly large incomes. Americans did NOT invest in manufacturing and other productive ventures. Americans did NOT invest in goods that lead to exports. Instead, average Americans invested in houses directly while firms and wealthy people invested in houses indirectly through firms that gave mortgages and insurances. As long as house prices did not fall, and were protected by the state (federal government), this seemed like a good strategy.

America went into recession (on schedule) in 2000. It never really recovered from that recession despite stimulus packages (raw money to the masses plus tax cuts for the rich) from the Bush administration. The recession lingered on because there still were no good places to invest and because we had deep underlying economic problems that we would not address. But the lingering recession was covered over by huge spending on wars in Iraq and Afghanistan, increased domestic security spending, boondoggles in the name of national security, and increased military spending overseas other than the obvious wars. Because the recession lingered on below the surface, there was still no good outlet for investment other than housing, and so the bubble continued growing.

In 2007, "the shit hit the fan" when the bubble could be sustained no longer. America went back into more obvious recession about 2006, and that was more than jerry-rigged structure could take. I do not explain here why the bubble burst at that time, or around that time. There are many good books on the subject now. The bubble had to burst sooner or later. It probably should have burst around 2003 but events staved off the collapse for a few more years.

Main Underlying Contributors.

-Capitalist economies have intrinsic "natural" levels of unemployment and poor employment (jobs with no benefits and low wages). We cannot eliminate unemployment and poor employment with any programs, tax cuts, or tax breaks. Unemployment and poor employment contribute to racism, sexism, ageism, discrimination based on religion, and class conflict. We have to deal with the problem directly through some kind of welfare. We have not done a good job of this.
-Welfare is intrinsically contradictory because people are tempted to become dependants of the state. The better we make welfare, the more that able people choose welfare over work. Yet we cannot make the poor find jobs, or find better jobs, simply by being nasty enough.

-America has "corporate welfare" in many forms. Corporations are tempted to become wards of the state, chiefly through lobbying efforts. Corporate welfare distorts the economy as much as welfare to private people.

-The above facts make it hard to design and run entitlement programs that pay for themselves and do not cause inflation.

-The worldwide average rate of unemployment among developed nations is at least 8%, with a few exceptions such as Germany and Japan. I do not know the worldwide average rate of poor employment. The United States kept its unemployment rate below 5% for many decades because the United States was the only maker of industrialized goods such as airplanes and computers. That situation is now over. Increasingly the United States faces unemployment and poor employment at world rates. As economic problems increase, so do social problems and political pressure.

-By definition, profit is revenue above costs. Profit is not needed to keep the economy going. Profit has to be invested in ways other than to keep the economy circulating. While America dominated the world economy, usually business firms could find ways to invest profits without hurting the American economy too much. Now it is much harder to find avenues for investing profits that are safe for both the business firm and the American economy. Increasingly firms look overseas.

-America has shifted from manufacturing hard goods (industry) to services. Under some conditions, this shift would not hurt the overall American economy. Under the conditions that have prevailed since about 1970, it has hurt the American economy because, in America, service economies offer less opportunity for investment than manufacturing does (in other countries, service can be an outlet for investment; but this overall story for overseas is not yet clear).

-Beginning after World War 2, the federal government interfered increasingly in the housing market, in many ways, though taxes and institutions. The intentions behind the interference were good, but, like many well-intended programs ("Bush tax cuts"), the overall effect was bad. Interference had two effects, which can be contradictory but really are not: (1) Housing became a good market to invest in. (2) Prices of houses rose. I estimate that prices for houses were at least 25% above what they would have been in a healthy market, even before the housing bubble, due to state interference. Even though prices were above what they should have been, because of state interference in the market, investment in housing was still fairly safe, and so people kept investing. If other events had not entered the picture, America might have been able to sustain this interference in the housing market.

-De-regulation played a part but I am not sure how large a part. Good regulations would have served as an early warning system. If politicians were inclined to heed such warnings, the crisis could have been averted. But politicians are not inclined to heed, so even with regulation, politicians probably would not have done what was necessary. I am not saying we do not need re-regulation. We do. But we should not expect regulation, and regulators, alone to save us from ourselves.

-Americans became materialistic and greedy. They developed unrealistic expectations of the material rewards of just being an American. Americans believed they deserved a huge house, and could afford one. We behaved like a nation of spoiled rich kids on a reality TV show. We indulged in massive self-deception for the worst reasons. Americans are still among the very best people in the world but they have a streak of "bust the Joneses" that can get ugly, and did. It is easy to blame "Wall Street" but, in the end, we have to blame ourselves.

-Beginning with Ronald Reagan, the federal government engaged in terrible economic policies of deficit spending and inflation. It does not matter which party is in power. Republicans annoy me most because they say they are the party of fiscal responsibility yet the worst abuses have been under their "watch"; they are the party of greatest hypocrisy. The deficit spending pumped more money into the economy that had nowhere to be invested.

-Beginning with Ronald Reagan, the net result of government economic policies has been to reduce the wealth of the poor and the middle class while greatly expanding the wealth of people and of business firms that are wealthy already. Again, some of this distorting interference might have been done with good intentions but the net result has quite bad and will continue to be bad. It is easy to judge the net result as bad simply on the basis of obvious evidence, regardless of your political orientation.

Why the Crisis Persisted So Long and Persists Now.

I focus on one reason: why housing prices will not fall low enough and fast enough, in particular the role of large financial institutions ("banks") in keeping the prices up. Other forces keep us in recession. Some of the other forces might be as important, although I am not sure. The reason I offer has not been offered very clearly by anybody else, as far as I can tell.

For the housing market to resolve and work near normally, I think the average price for a house in the United States would have to fall about 40% to 50% from the average price in 2008. To be sure of a near normal housing market, the fall in average price would have to be at least 50%. This level does not mean the price would fall for every house, every type of house, in every market. Some houses are correctly priced already. Some might even be under priced.

If housing prices fell to the appropriate level that a free market would seek, despite some initial pain, the economy as a whole would recover, more people would go back to work more quickly at comparatively higher wages, more people could buy houses, people would buy the appropriate house that they could really afford, and we would all be better off. So why don't house prices fall? (1) The state (the federal government) keeps the terms of adjustment for mortgages high so as to protect buyers in trouble. (2) Banks refuse to allow terms that might lead to any kind of loss on their financial statements. Only when inflation has caused other prices to rise to the money level of house prices will the state and the banks allow market forces to operate, and house prices to "float". Of course, house prices cannot also rise at the same time. House prices have to remain stable or fall modestly while other prices rise. I am not sure when we will reach the "break-even point" because I cannot get accurate figures on the overall inflation since 2007. It seems as if it is beginning to happen in 2012. It might be under way on a large scale by about 2014, especially if Barrack Obama is re-elected and does not feel the need to keep housing prices safe. If Mitt Romney is elected instead, and looks to 2016, then he will probably take measures to protect house prices and the banks, and so keep recovery slow.

(Suppose, in 2008, an over-valued house cost $300,000 and a bag of apples cost $3. If general prices double but house prices stay the same, in 2015, the house will still cost $300,000 but the bag of apples will cost $6 – this seems to be the actual trend. In that case, the "real" price of the house in 2008 dollars would be $150,000 even though the "money" price in 2015 dollars is $300,000. Then, house buyers and banks can dispose of houses without taking a loss in money terms although they would take a loss in real terms. Money terms are more important for these cases.)
Inflation is happening, and, for working people buying groceries, it is happening at a rate higher than official statistics indicate. I guess that inflation is at least 10% per year. At the rate of 10% per year, it will take general prices 7 years to double, so that house prices will, in effect, be reduced by 50% after 7 years

- If house prices do not also rise. At a rate of 12% per year, it will take general prices 6 years to double, so house prices will, in effect, be reduced by 50% then. This is the basis for my guess of about 2014 for a real resolution to be obvious but not complete.

If the state did not protect over-extended house buyers, then many of them would have to give up their houses. They would suffer a lot for a short time. As far as I am concerned, they should suffer a bit for their selfishness. Yet they would vote against the party that allowed them to suffer. Collateral industries such as construction and insurance would suffer too, and would vote against current politicians. To protect themselves, state officials protect a large group of clients. If state officials allow general prices to rise while house prices remain the same, then, after 7 years, this group of clients can sell their houses without a money loss, not feel as if they have suffered, and not vote against the officials. In fact, they are likely to vote for the officials. In the meantime, everybody else suffers, but, so far, that does not seem to “translate into” anger at state officials and voting against state officials.

I think the power exerted by the banks is even more important. Banks “hate like hell” to show any kind of financial loss, in money terms, on any kind of investment, on any statement. If banks wait long enough, general prices climb high enough, house prices do not climb, and house owners sell over-extended houses at the old pre-inflation price, then, on paper, it will seem as if the banks did not suffer a loss. As long as the banks can see that the state is allowing some inflation, the banks only need to wait until the inflation increases general prices so it appears as if the banks do not take a money loss on over-extended houses. As long as the banks can see that the state is allowing some inflation, and the banks want some inflation, there is no reason for them to offer new mortgages and new business loans now that will be undercut by the inflation. They can, and should, wait until the mortgage crisis is resolved in their favor, the rate of inflation is under control at less than 10%, and they can offer loans on terms favorable to themselves. In the meantime, banks can use their large assets to invest in other markets, in particular overseas. They can invest in markets that are not as likely to be hurt by current American inflation. As far as I can tell, this is just what happened.

Between 2008 and 2012, American firms created well over 1,000,000 jobs overseas. In effect, the banks have held the state hostage while waiting for conditions to resolve in their favor.

The trick for state officials is to allow the right rate of inflation so eventually general prices rise enough to make houses sellable again, while not allowing inflation to come fast enough to make people in general feel it and complain loudly. I can’t tell if Obama administration officials know what is going on and are deliberately following this strategy. It appears the Obama administration has hit that balance with an inflation rate of about 10% to 12%. I do not know if this has happened on purpose, by accident, or with luck. It is lucky for the administration. It is not lucky for the general public. I guess the administration fell into this solution, figured out what was happening, and is going along with it, hoping things will get better just fast enough still to be re-elected in 2012. I am certain that a Republican administration would have done no better. The Republican Congress elected in 2010 did do a lot worse.

What to Do in the Short Run.

Stop supporting bad housing contracts (mortgages, etc.). Let people “under water” sink. Tolerate a spate of bankruptcies and defaults. Let housing prices float. Banks have to accept some losses on their annual statements. Believe it or not, people will not die if they lose their overly-large house. People will learn to live within their means. People will learn to live in smaller houses and in apartments. People will adjust the size and type of their dwelling to their income.
Stop inflation as much as possible. Reduce the budget and the debt.
Unfortunately, I can think of no politically possible way to force state officials and banks to allow house prices to fall more quickly to the right levels, and to stop inflation. Now that we are in the pattern described above, I do not anticipate coming out of it until prices adjust through inflation, maybe sometime around 2014.

What to Do in the Medium Run of less than 5 Years.

Stop all interference in the housing market. Stop allowing house buyers to write off house payments on their taxes. Provide legal protection for house buyers but not much financial support. Dissolve Fannie Mae and Freddie Mac, the state organizations that help house buyers. Stop financial support of banks, insurance companies, and other financial institutions that manipulate mortgages. Institute regulation and institute greater penalties. I doubt that any of this is politically possible either. I don’t know what to do that is really politically possible.

What to Do in the Long Run.

Face the problems with unemployment, poor employment, personal welfare, and corporate welfare, and deal with them. End all corporate welfare.

Figure out how to allow more investment in America without much government intervention. I always like research, as with the space program. We can research “green” energy and bio-tech. We should not do anything to force more investment, such as tax breaks or protection.

Totally reform and simplify the tax system. End all deductions for anything.

Reverse the changes begun by Ronald Reagan so that there is more equity in taxes and so that wealth disparity stops getting larger. Don’t deliberately move money from the wealthy but quit channeling money to the wealthy from the poor and the middle class.

Stop inflation.

Reduce the military budget.

Make sure entitlement programs such as Medicare and Social Security pay for themselves.

I doubt any of this will happen either.