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Graciela Chichilnisky

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Posted: November 17, 2008 02:21 PM

It's the Mortgages: How to Restore the Health and Stability of the Economy

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An extremely important fact has been absent from the analysis of the financial crisis and is jeopardizing the opportunity to resolve it effectively. The astonishing scope and spread of the crisis is due to a snowballing effect that amplifies defaults on mortgages from 33 to 100 times the value of the assets at stake, magnifying and spreading them into defaults and bankruptcies across the entire world financial system. Therefore, to resolve the financial crisis one has to stop the defaults on mortgages right now. These defaults are the true root cause of the larger financial crisis.

Ending defaults requires minimal intervention from Congress, minimal international cooperation in lowering bank rates to prevent currency swings, and costs the tax payer virtually nothing. The key is decreasing the monthly payments on mortgages by fifty percent or by an amount consistent with the Housing Price Index. The details matter, but in any case, doing this can make the mortgages more affordable and better aligned with lower property values.

The approach works by enabling homeowners to meet their monthly mortgage payments and by making it worthwhile for them to do so. The size of their mortgages will no longer exceed the value of their homes. The banking system is stabilized because banks receive continued payments of fifty cents on the dollar providing them with an infusion of capital. Reduced bank discount rates can be arranged to match and sustain bank balance sheets. This one-two punch can stem the wave of defaults and bankruptcies and stabilize the banking system. The move will also help stabilize real estate prices which go up with good mortgage terms.

An important additional benefit is that the plan works as a tax rebate: homeowners will have more money in their pockets thus stimulating the economy, increasing spending and creating jobs.

With its recent $700 billion bailout, the government is trying to deal with the effect and not with the cause. The true root cause of the financial crisis starts with the continued defaults on mortgages that magnify and snowball throughout the entire financial system due to a historic combination of financial innovation and deregulation.

Here's how it works. Each mortgage became part of widely traded "mortgage backed securities." Freddie Mac and Fannie Mae fueled the process by buying about $5.2 trillion worth of mortgages from the banks, representing about 40% of the $12 trillion in total US real estate assets. On top of that, many financial institutions traded a large number of derivative securities such as interest rate swaps and options based on mortgage backed securities that can magnify gains and losses by a factor of two or three. They were able to leverage their assets 33 to 1 due to deregulation. They borrowed, lent and traded 33 times more than the value of their assets. This way each mortgage default is magnified and snowballs into trades worth 33 to 100 times more than the original mortgages. The derivative market itself is now worth $530 trillion, and credit default swaps that are purchased to insure against default add to $54.6 trillion.

The process is a money making machine when things go well -- it hugely magnified gains as real estate prices went up. When prices go down, however, it hugely magnifies and snowballs losses. Alan Greenspan noted this dynamic as early as 1992, when he warned in his testimony at a Congressional hearing that derivatives could amplify a crisis: "The very efficiency that is involved here means that if a crisis were to occur, then that crisis is transmitted at a far faster pace and with some greater virulence"

Today 9.15% of all mortgages are in default, about twice the historical standard, representing about $1 trillion in assets, but this percentage could still increase to 30% or more. Since each mortgage default snowballs into 33 to 100 times the initial value, this leads to widespread defaults and bankruptcies in financial institutions. The key to solving the problem is to stop the snowball when it is small and not after it grows huge and impossible to contain.

The $700 billion bailout deals with the after-effects, provides liquidity and buys out some mortgage backed securities, derivatives and mortgages. But it does not deal with the true root cause. Unless we stop the continued mortgage defaults the financial crisis will continue and will get worse: defaults, foreclosures, bankruptcies, unemployment and a painful economic contraction.

In sum: restructure mortgages now, fifty cents on the dollar or appropriately adjusted according to the price index. Stop the continued defaults and offer discounted bank rates and the banking system will stabilize. This proposal, or something close to it, is virtually the only thing that will work, and it can work fast.

Graciela Chichilnisky is Professor at Columbia University in Mathematics and Economics. She is an expert in short sales and asset backed securities, financial innovation and widespread default, has created financial instruments known as 'catastrophe bundles,' and is the author of the carbon market of the Kyoto Protocol of the United Nations.

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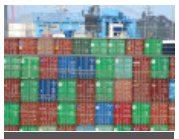
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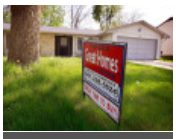
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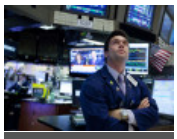
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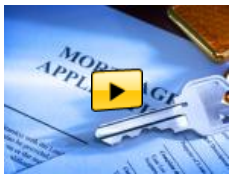
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as of Aug 11, 1:13 PM EDT

S&P 500	1161.88	+41.12	+3.67%
NASDAQ	2468.19	+87.14	+3.66%
NYSE	7186.34	+248.11	+3.58%

Gainers | Losers | Most Active

AONE	$4.46	+1.29	+40.69%
IL	$8.29	+1.65	+24.85%
SOL	$3.97	+0.74	+22.91%
TPCG	$33.87	+5.50	+19.39%

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californiadreamer
7 Fans

03:46 PM on 12/02/2008

I don't pretend to understand the fine print of the argument, but I do know intuitively that we have to figure out a way to help the homeowner and wage earner survive this current recession. If we don't then the world financial equilibrium starts to topple. It the wage earner can't afford to buy the TV to place on the wall of his home that has an affordable mortgage, then the factory worker in South Korea, the shipping company from Liberia, the discount store in Ohio, all these entities are impacted. The American consumer is the key to the world economy or so I'm told. Perhaps we have over-consumed and obviously we will consume less in this recession, but we need to have some cash in order to do so. Reducing adjustable rate mortgages to free up dispensable cash will help. There are those who have equity in homes and cash in the bank and are feeling like they should be rewarded for their financial rectitude, and perhaps they should, but right now, we need to do something to salvage a world economy or we'll all be on the street corner selling apples. There is no easy solution, but we must find an answer. The credit crisis got the government attention fast and they poured billions into it. Banks are not folding, but unless the government can find a solution to prevent defaults, tnen the banks and everyone else will be pulled under by the housing market implosion.

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Sundialsvc4
530 Fans

08:52 AM on 11/19/2008

Dr. Chichilnisky, I aver that you might be looking at only one part of this elephant and seeing the whole.

Yes, "we must stop defaults," but how? People default on loans either because they cannot pay them or because they quite-rightly perceive that they are a sucker for doing so.

During the night, the leprechaun's gold seems real. In the morning, though, it's what it always really was: a sackful of stinking wet straw. The leprechaun's gold looked just fine to the bankers, AND to the "any civil officers" of the Government who were supposed to be hunting those leprechauns. Nobody was interested in producing things anymore... all during the night, the leprechaun's gold was sent to far-away places and, as if by magic, boxes of stuff came pouring back. Then morning came.

And yet, here we are, still looking at "money." It's not about the money: it's about things. What is in those boxes, and more importantly, where those boxes came from and who actually made what's in it. EVERYONE got fleeced by the leprechaun, and by daylight we're still looking at those ledgers where, just the night before, we thought that "all that money" was.

I think we need ... to get to work. Here. Now.

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Henry
46 Fans

09:52 PM on 11/18/2008

"They borrowed, lent and traded 33 times more than the value of their assets."

I really think you meant to say that they borrowed 33 times their respective net worths or equity positions.

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HUFFPOST SUPER USER
Tellurider
4 Fans

04:31 PM on 11/18/2008

I like the thinking. We have to do something to stop the foreclosures.
Your plan would work for me with just a couple of tweaks.
First, to have the plan not be a give-away or a bail-out there needs to be a "deed restriction" placed on the home that assures that the owner lives in the house, and owns no other home in the region. Also, you need to put a 3% annual cap rate on the home for sale purposes so that it stay affordable to future generations.
In our country, we call this Workforce Housing and it is used extensively in the ski resorts and many cities to make home ownership affordable for gainfully employed, essential (teachers, nurses, etc.) workers in our communities.
China just announced their plan to build 4 million affordable ownership homes.
The reason it is not a give-away is that the home owner has to buy into the program by forfeiting the homes "free-market" standing and agreeing to a 3% cap rate and helping to launch a national workforce housing program.

The plan does not encouage homeowners that own or bought a home they can afford trying to jump in on a "bail-out" because it is not a give-away. You have to buy into the plan to participate.

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Baltotoast
7 Fans

12:32 PM on 11/18/2008

Great...except for one small detail...in this country we have something called rule of law - contracts. ..Perhaps you have never heard of them? Anyway, writing mortgages down by 50% would greatly exacerbate the financial crises because these mortgages have been securitized and are now held by banks, mutual funds, pension funds, endowments,etc. Do you really want them to take a 50% cut on their values? We wish it was as easy as you describe, but your argument is intellectually dishonest as it omits a key and well known group that adamantly opposes anything of this kind - and has the force of law behind them.

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RoloTomassi
78 Fans

12:54 PM on 11/18/2008

Please, your condescending tone does not hide the fact that you're talking an agenda that is self-serving and completely unrelated to the reality of the situation; these institutions have no qualms about asking the US government to alter existing laws in their favor. We should have no qualms in asking these institutions to modify standard practices in order to help the overall environment.

Besides, if you're half as smart as you try to project, you know very well that alterations can be made quite easily in this sort of dire situation.

You reveal yourself to possess an abhorrent corporatist mindset; obviously you have not objections to corporations manipulating the situation for their gain, but find counter measures on behalf of the taxpayers involved to be illegal and unethical.

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Baltotoast
7 Fans

01:33 PM on 11/18/2008

Look who has the condescension thing going strong...

My objection to this screed is that it is utterly misleading as to the ramifications of this program and its impact - NOT necessarily on investment banks, but also on pension plans and ordinary people who will see their financial assets further damaged. And in contrast to what you say, it is relatively east to modify mortgages that are still held by banks, but it is really, really hard to modify mortgages that have been securitized (or else it would have been done by now).

Not sure how you got from there to your hysteria about "corporatist" - clearly your ideology allows you to ignore fact.

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