Written Testimony of Mark Zandi
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Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

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I will make three points in my remarks.

First, the economy is likely in the midst of a recession. Real GDP growth slowed sharply during the last quarter of 2007, and the economy appears to be contracting in early 2008. The job market has stalled, retailers are struggling, and manufacturing activity is weakening.

Recession-risks are evident in the increase in unemployment during the past year. The unemployment rate has risen by half a percentage point from its 4.4% cyclical low last March to 4.9% this January. Recessions are always preceded by such a rise, and such a rise has never occurred and a recession not ensued. The economic reasoning behind why higher unemployment is the catalyst that sets off the vicious cycle that characterizes recession is that increased joblessness undermines consumer confidence and thus consumer spending. Businesses respond to flagging sales by cutting back their investment and payrolls, and unemployment rises further. A negative self reinforcing cycle begins.

A number of large state economies are already in recession, including Arizona, California, Florida, Michigan and Nevada.[1] These states account for one-fourth of national GDP. Fifteen other states, including Alaska, Arkansas, Connecticut, Georgia, Hawaii, Illinois, Kentucky, Minnesota, Missouri, Montana, Ohio, Rhode Island, Vermont, Virginia and Wisconsin are very near recession. These states account for an additional close to one-fourth of national GDP. The large metro area economies of the Northeast, extending from Boston to Washington DC are still expanding, but growth is sharply slowing, particularly around New York City which is being hurt by Wall Street's travails. If these economies devolve into recession, then a national recession will occur.

My second point is that the most fundamental source of the economy's problems is the unprecedented housing downturn and resulting surge in mortgage loan defaults and foreclosures. Housing activity peaked nearly three years ago, and since then home sales have fallen by approximately 35%, housing starts by nearly 60%, and house prices by 10%. Some two-thirds of the nation's housing markets are currently experiencing

[1] Regional economies are determined to be in recession using a similar methodology as employed by the National Bureau of Economic Research in determining national recessions. Payroll employment and industrial production are the two principal economic indicators used for the basis of whether a regional economy is experiencing a persistent broad-based decline in economic activity.

substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor and the industrial Midwest.

Further significant declines in housing construction and prices are likely through the end of the decade as a record amount of unsold housing inventory continues to mount given the ongoing turmoil in global financial markets and its impact on the mortgage securities market and thus mortgage lenders and the recent weakening in the broader economy and job market. I expect national house prices to ultimately decline by close to 20% from their peak to their eventual trough.[2] Even this disconcerting outlook assumes that the Federal Reserve will continue to ease monetary policy and that the mortgage securities market revives this spring.

Residential mortgage loan defaults and foreclosures are surging. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and the weakening job market are conspiring to create the current unprecedented mortgage credit problems. According to very accurate data based on consumer credit files, there were 550,000 first mortgage loans in default (the first step in the foreclosure process) as of the end of January, 2008.[3] This equates to some 2.2 million defaults at an annualized pace. Even if mortgage loan modification efforts increase measurably in coming months, I expect well over 3 million mortgage loan defaults this year and next. Of these, 2 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial.

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[2] See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.
[3] The source of this data is a 5% random sample of all the nation's consumer credit files maintained by credit bureau Equifax. The sample is drawn at the end of every month.

The unraveling of the housing and mortgage markets continues to undermine the fragile global financial system. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion.[4] The losses publicly recognized by financial institutions to date amount to no more than $150 billion. Losses on construction and land development loans made by the banking system to homebuilders are sure to increase measurably in coming quarters and the credit problems on other consumer loans are rising rapidly, particularly in those parts of the country in recession due to the housing downturn. These stresses are also exposing other weak spots in the financial system, including the monoline insurance industry and the credit default swap market. Given the opacity of the global financial system, it is unclear who are at most risk, and as such players in credit and equity markets remain on edge; unwilling to extend credit to each other. The availability of credit has been impaired and the cost of capital has risen for nearly everyone, good credits and bad, and the negative economic repercussions are mounting.

The housing downturn is also undermining consumer spending. Even a modest pull-back by consumers will push the economy into recession, as such spending accounts for 70% of the nation's GDP. The odds of such a retrenchment are high given that the saving rate of the one-third of households who are homeowners and have borrowed against their homes in recent years is an estimated negative 10%.[5] If this group, which also accounts for about one-third of all consumer spending, simply matches its' spending to its income

[4] See "Leveraged Losses: Why Mortgage Defaults Matter," Jan Hatzius, Goldman Sachs US Economic Research, November 15, 2007. "A Macro Look at Subprime Losses, ARMs and Convexity Hedging," Alec Crawford, RBS Greenwich Capital, November 2007.

[5] The personal saving rates for difference groups within the population is derived based on data from the Federal Reserve's Survey of Consumer Finance and Flow of Funds. Renters and homeowners who have not cashed-out homeowners' equity, each accounting for about one-third of the population, have close to zero saving rates.

over the next several quarters, the negative impact on overall consumer spending will be substantial.

My third point is that while a recession is likely unavoidable in coming months, it will take deft and aggressive monetary and fiscal policymaking to ensure that the downturn will be short and modest.

Indeed, the last two recessions in 2001 and 1990-91 were short and mild by post World War II standards, but only because of the aggressive monetary and fiscal stimulus provided to shore up the economy. In the early 1990s downturn, the real federal funds rate fell from 5% to 0% and the federal budge deficit increased from 3% to 5% of GDP. Early in this decade, the real funds rate fell from 4% to -1% and a surplus of 2% GDP turned into a deficit of 4% of GDP.

Policymakers' initial response to last summer's subprime financial shock was very tentative, as they misjudged its severity and the extent of its economic fallout. Financial markets and the economy subsequently eroded. The Federal Reserve finally reacted in dramatic fashion in late January, substantially changing the conduct of monetary policy and slashing the federal funds rate target in an unprecedented way. Equally as dramatic was the quick passage in February of a sizable and reasonably well-designed fiscal stimulus package. In addition to a tax rebate for households and investment incentives for business, the stimulus raises the current mortgage loan caps on the FHA, Fannie Mae and Freddie Mac. This should result in increased mortgage lending in particularly hard-hit housing markets such California, southern Florida, and around D.C. and New York

City. The stimulus also authorizes more state tax-exempt bond issuance to fund the mortgage refinancing efforts of stretched homeowners.

While substantial, this recent aggressive policy response may very well be insufficient to resurrect the global financial system and fully revive the economy. As long as credit and equity markets and the banking system fail to find their footing, the economy will struggle. The economy may even begin to recover this summer, lifted by the fiscal stimulus package. Without a healthy financial system, however, any recovery will prove weak and disappointing.

Moreover, confidence that financial markets will work through their problems aided by lower interest rates and some coaxing by the Treasury Department appears increasingly misplaced. The financial system may not be up to the task of re-starting itself, at least not quickly enough. A more aggressive policy response, specifically targeted to the problems in the nation’s housing and mortgage markets and financial system, seem necessary. At the very least policymakers should be planning as if there efforts to date are not sufficiently successful.

One such response is proposed legislation to allow subprime first mortgage loans originated during the period when underwriting was its most frenzied to be cramdowned in a Chapter 13 bankruptcy filing. The appropriate cramdown would be determined by a bankruptcy judge and could include the reduction in mortgage principal owed to the appraised value of the home, a lower interest rate, and/or changes in the loan’s maturity. Under current bankruptcy law first mortgages are exempt from any such changes so that homeowners are unable to effectively use bankruptcy to avoid foreclosure. This legislation would be an effective way to quickly induce more substantive loan modifications.

Other more creative steps are preferable and increasingly possible. One potentially attractive idea is to establish a taxpayer-financed fund to buy up mortgage loans and mortgage securities. This could be done via an auction process, in which mortgage owners would sell mortgages and securities to the government at a steep discount; just how deep a discount will be determined by the bidding. An immediate benefit would be to provide liquidity to the frozen securities market which would reduce pressure on the entire financial system. The process would also provide a clear price for mortgage securities, thus facilitating efforts by financial institutions to appropriately mark-to-market their mortgage holdings. Their inability to do so has resulted in widespread uncertainty and angst in the financial system, contributing to its current problems.

The government, now the new owner of mortgages purchased through the auction process, could also work to forestall foreclosures and thus shore up the housing market. They could, for example, refinance a homeowner into a smaller, and thus more manageable, FHA loan. While the borrower would only have to make payments on the new smaller loan, they would still owe the government the difference between the new and old loan. When the homeowner eventually sold, any proceeds would have to be used to fully repay the government, thus ensuring that no homeowner receiving help would make a profit at the expense of taxpayers.

The total cost of the plan would ultimately be very modest. At the extreme, the upfront cost would be approximately $250 billion, assuming the federal government purchased all 2 million loans that are expected to end up in foreclosure through the end of the decade at a 30% discount to their original value. According to the FDIC, this is just about the ultimate cost to taxpayers (in today's dollars) of the early 1990s savings and loan crisis via the Resolution Trust Corporation. Of course, the government would not lose all $250 billion, as many of these homeowners would be able to remain current on their new lower mortgage amount. Even if only half of homeowners were to be good payers, which seems pessimistic, then the ultimate cost to taxpayers will certainly be no more than that of the recently-enacted fiscal stimulus plan.

While this proposal certainly has some difficult problems to solve – how for example does the federal government evaluate bids by those selling mortgage securities, and how would second mortgage holders be treated? – and while it may now sound a bit etreme, so did freezing ARM payments and lifting Fannie and Freddie's mortgage lending caps just a few months ago.

What policymakers decide to do or not do in coming weeks will determine whether millions of Americans lose their job through the end of this decade and will have a significant bearing on the economic well-being of everyone else.