

Conference on
“The Deflating Mortgage and Housing Bubble, Part II”

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Opening Remarks

Alex J. Pollock

Welcome to our discussion of “The Deflating Mortgage and Housing Bubble, Part II: The Financial and Political Risks.” Part I was our conference last March, the pessimistic outlook of which has been confirmed by subsequent events. Six months later, it’s time for an update and to consider, “What now?”

This conference is jointly sponsored by the American Enterprise Institute and the Professional Risk Managers International Association. On behalf of both, we are delighted to have you all here.

I am Alex Pollock, a resident fellow at AEI. I will introduce our outstanding panel in a moment.

As we all know, in place of the previous housing and mortgage credit boom, we now have a big subprime mortgage and housing bust, which keeps generating events of obvious financial, economic and political importance.

The default rate on subprime mortgages reached a record high of 14.65% in July. Standard and Poor’s has recently forecast that subprime mortgage losses will not peak until 2009. House and condominium prices are falling on a national basis as measured by the S&P/Case-Shiller Index; Goldman-Sachs has predicted they will fall 7% a year for two years. Such a drop would represent about a \$3 trillion loss of household wealth in this most important and most leveraged household asset.

Homebuilders’ earnings have been crushed and for-sale inventories of both new and existing houses are high. About 100 subprime lenders have closed and subprime credit has been drastically withdrawn from the market. Mortgage credit has significantly tightened, so that we have reduced demand for houses at the same time as excess supply. As Desmond said last spring, we can probably work out what that means for prices. And falling house prices are likely to induce still further mortgage defaults.

Needless to say, the subprime bust triggered a credit market panic in August. This reflected great uncertainty about whether prices and credit ratings of securities made from subprime loans were meaningful, together with fear about how big the losses could be and who might be overextended or broke. Subsequently, numerous investment banks and banks have announced multi-billion dollar write-offs.

John Maynard Keynes memorably remarked that “a prudent banker is one who goes broke when everybody else goes broke.” We can update that to: “A prudent CEO is one who has multi-billion dollar write-offs when everybody else has multi-billion dollar write-offs.” The market seems to have gotten used to the idea and while housing sinks, stock prices are making new highs.

Opinions about the macroeconomic effects of the housing bust range from forecasts of recession and Alan Abelson’s “the worst isn’t over...we haven’t truly begun to feel the full effects,” to Brian Wesbury’s “all systems are go for rapid economic growth in the quarters ahead.”

Politically, Washington is full of hearings and proposals, from expanding the FHA, Fannie Mae and Freddie Mac, to changing bankruptcy rules, to pressuring mortgage servicers to modify loans, to my own one-page mortgage disclosure form.

So: How do we best understand where we are now and where housing and mortgage finance are heading? What will the macroeconomic effects of the bust be? How do we size up the various political proposals?

Our panel will address these and other pertinent questions.

We will hear first from Desmond Lachman, who is a Resident Fellow at AEI, having previously been a Wall Street economic strategist. His research includes global currencies, emerging market economies, multilateral lending institutions, and the housing bubble. Desmond and I have been reinforcing each other’s bearish outlook on this for over a year now.

Tom Zimmerman will be our second speaker, again bringing us first-hand securities market perspective. Tom is a Managing Director at UBS Investment Bank, where he manages the firm’s mortgage credit and asset-backed securities research. His research has appeared in numerous fixed-income reference works, and he is a member of the UBS team voted first in the latest Institutional Investor survey of fixed-income analysts.

Next will be Nouriel Roubini, who is a professor of economics at the New York University Stern School of Business, as well as Chairman of Roubini Global Economics. He has served as the senior economist for international affairs at the White House Council of Economic Advisers, among many other assignments, and written provocatively on the housing bust and its economic implications.

Our fourth speaker will be Chris Whalen, Senior Vice President and Managing Director of Institutional Risk Analytics, to which he brings experience as an investment banker, research analyst and journalist, including working in both equities and fixed income, as well as risk management. Chris has been my excellent partner in organizing this conference.

Finally, we will hear from John Makin, who is both a visiting scholar at AEI, where he writes the insightful monthly “Economic Outlook,” and a principal at the investment firm of Caxton Associates. He has been an adviser to various U.S. government agencies, as well as the Federal Reserve and the Bank of Japan, and is the author of numerous books and articles on finance and economics.

Each member of the panel will speak for 12 to 14 minutes, after which we will give the panel a chance to respond to each other. Then we will open the floor for your questions, with adjournment not later than 4:15. And now the panel.