



LINDA SMOGOR



# Busted

## Dean Baker On The Price We're Still Paying For The Housing Bubble

ANNA BLACKSHAW

**I**n 2002 the unprecedented growth in the housing market was widely viewed as evidence of a healthy economy, but to economist Dean Baker the numbers did not add up. That year he published a prophetic brief, *The Run-up in Home Prices: Is It Real or Is It Another Bubble?* For the first time ever, Baker observed, housing prices were far outpacing inflation and rent increases. Aided by lower interest rates, looser credit standards, and questionable lending practices, the already indebted were taking on more debt, believing the boom would continue. Baker predicted a bust and prescribed reining in the institutions that were encouraging the bubble. As he tells it, his predictions were dismissed or ignored.

Today Baker is widely acknowledged as being among the first economists to have pointed out the bubble, but when asked about his prescience, he says, "Any competent economist could have seen it. They just had to look. Most chose not to."

Baker has long been a lone voice in a profession dominated by those who recommend tax cuts for the wealthy and privatization and deregulation as means to promote economic growth. Baker reframes common assumptions about economic issues. It is not the market, he says, but "very human policy choices" in macroeconomics, trade, labor management, immigration, and other industries that have cumulatively weakened the earning power and economic security of the middle and lower classes. Conservatives have smartly learned to use the market to achieve

their policy goals. That same system, he says, can be used just as effectively to distribute wealth differently. He sees the current crisis as an opportunity to challenge the conventional thinking and start rewriting the rules of the marketplace. Progressives "have to understand economics to make progress," Baker says. "Well-intentioned policies that lead to bad economic outcomes will not advance social justice."

Baker grew up in Chicago and attended Swarthmore College, graduating in 1981. He began his studies as a history major, but as his interest in world affairs grew, he found that the issues he cared most about were economic at their core. He didn't agree with the trickle-down theories promoted at the time, which said that tax relief at the top would eventually benefit everyone, and he earned an economics degree so that his challenges to the status quo would be taken seriously. He went on to get his PhD in economics from the University of Michigan.

In 1999 Baker and fellow economist Mark Weisbrot founded the Center for Economic and Policy Research (CEPR), and they serve as its codirectors ([www.cepr.net](http://www.cepr.net)). He exposes biased economic reporting in the media in "Beat the Press," his popular blog for the American Prospect ([www.prospect.org](http://www.prospect.org)). His writing has been published in the Washington Post, the Atlantic, and the London Financial Times, and he is the author of several books, including *Plunder and Blunder: The Rise and Fall of the Bubble Economy* (PoliPointPress), *The Conservative Nanny State: How the Wealthy Use the Government to Stay Rich and Get Richer* (Center for Economic and Policy Research), and, with Mark Weisbrot, *Social Security: The Phony Crisis* (University of Chicago Press).

I spoke with Baker one rainy afternoon at a busy cafe in Dupont Circle, a few blocks from CEPR's offices in Washington, D.C.

**Blackshaw:** What is the story behind the current financial crisis?

**Baker:** The basic story is that we had a huge housing bubble, and housing is central to the economy. Most people have little or no stock and perhaps some money in a savings account, but their most important asset is their house. The rise in housing prices sparked huge surges in residential construction and consumer spending. If people's houses went up \$100,000 in value, they would spend more, because they assumed it was real wealth. This seemed a perfectly reasonable thing to do. So we had a bloated housing sector and a huge consumption boom, both of which were not sustainable.

What is key in a bubble is that people see prices increase and expect them to increase further in the future. A couple may look at a \$300,000 house and think that it's too expen-

sive for them. But if they expect it to be worth \$400,000 in three to four years, then they would make a very different calculation. If they somehow can make the mortgage payments over this period, they come out as big winners. People thought they were doing just fine because they had significant equity in their homes, even though they might not have had much in their retirement accounts. When the bubble burst, most of that home equity just disappeared. All these middle-class people who thought they were saving money now found themselves with nothing. Housing construction collapsed, and consumption plummeted, throwing the economy into a steep recession.

There were other contributing factors to the bubble. Bad loans and deregulation of financial markets all allowed it to grow much larger than otherwise would have been possible. But the price of houses was at the center.

**Blackshaw:** You have said that the tragedy of the economic crash is how preventable it was. Can you explain?

**Baker:** It was easy to see it was a bubble. We had an unprecedented run-up in house prices. If you look back a hundred years, from 1895 to 1995, housing prices nationwide were on track with the overall rate of inflation, but in the mid-1990s they began to hugely outpace inflation. By 2006, after you adjust for inflation, they had risen more than 70 percent. This created more than \$8 trillion in housing “wealth.” It should have been easy for any economist to see, but Alan Greenspan, the chair of the Federal Reserve Board, either didn’t see it or, more likely, saw it but let it keep growing to ever more dangerous levels and just figured it would work itself out. The Federal Reserve Board is most directly responsible for preventing bubbles and could have taken any number of measures to prevent the run-up in house prices.

**Blackshaw:** What should the Fed have done?

**Baker:** Well, most immediately what Greenspan should have done was just talk. He should have used every forum he had to say that there was a housing bubble. He should have documented the case as clearly and unambiguously as possible and said that if we did not do something, it was going to collapse and cause real problems. Greenspan testified before Congress at least two times a year and gave public speeches that received enormous attention. He knew that people were listening. The government had the regulatory authority to stop this. But instead Greenspan said that there was no bubble, citing research that it was just a problem of inaccurate price measurements.

The Federal Reserve Board employs thousands of economists; he could have had them all working on documenting the evidence that there was a bubble. Had he done that, it would have made people more fearful about buying homes, and it would have made the banks fearful about making these loans. But he made about as big a blunder as anyone could possibly



DEAN BAKER

make. Or he did it deliberately, take your pick. Either way he certainly did nothing to stem the growth of the bubble. In fact the Fed arguably took steps that encouraged the bubble.

**Blackshaw:** Didn’t Greenspan also dismiss growing concerns over the questionable lending practices that became more widespread as the bubble grew, including the predatory practices that disproportionately preyed on low-income families?

**Baker:** It is inconceivable that he did not know about the bad mortgages that were being made. In the 1990s and the early part of this decade subprime mortgages made up about 8 percent of the market; by 2006 they exploded to 25 percent. The Federal Reserve Board should have cracked down on the mortgage fraud that was taking place, but Greenspan

was encouraging it. In 2003, when long-term fixed-interest mortgage rates — the safest choice for buyers — were almost at a fifty-year low, Greenspan said that more-risky adjustable-rate mortgages (ARMs) were often a better option. With an ARM the mortgage payment is lower to start but can steeply increase if interest rates rise, possibly becoming higher than the homeowner can afford. He later said that he was not advising people to get ARMs, but his opinion was widely cited by mortgage brokers who gave the green light for millions of people to get ARMs and the other bad mortgages that helped fuel the bubble.

**Blackshaw:** At what point did you first become aware of the bubble?

**Baker:** I noticed it in 2002, after Greenspan gave testimony that there wasn’t one. His arguments did not make any sense. He cited four factors that supposedly provided a basis for the rapid rise in home prices: shortages of land, environmental restrictions on new construction, rising incomes, and growth in population. But they did not square up. Environmental restrictions had been in place since the 1960s and had not become stricter in the 1990s. Income growth was not particularly strong at that time, and population growth was actually slowing. There was no obvious reason why the supply of land should have suddenly pushed up housing prices. Plus, if it had been supply and demand in the housing market causing these huge price increases, one would have expected comparable increases on the rental side, but rents were going nowhere.

I started looking more closely at the historical trends and found that for forty-five years housing prices had kept in step with inflation, and suddenly they were outpacing it. That seemed like a bubble to me.

*(end of excerpt)*