

RESEARCH BUZZ



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Is the Financial Crisis Causing a Recession?

By Dr. John A. Tatom
john.tatom@isunetworks.org

It's official, the U.S. entered a recession a year ago in December 2007. The National Bureau of Economic Research, the official arbiter for dating business cycle developments, announced on December 6, 2008 that the economy had reached a peak in December 2007, following a long expansion that began in November 2001. Coming in train with a foreclosure crisis that began in late 2006 and its associated financial crisis that began in August 2007, there is a tendency for analysts to attribute the recession to the financial crisis. Did the extreme conditions in financial markets since September 2008 cause and/or worsen the recession, or were there other causes? Knowing the cause(s) of the current recession could be essential to determining how much longer and deeper the current recession could be.

The worst aspects of the financial crisis that attract attention today did not begin until September 2008, when credit markets were said to seize up or freeze, according to the metaphor of the mo-

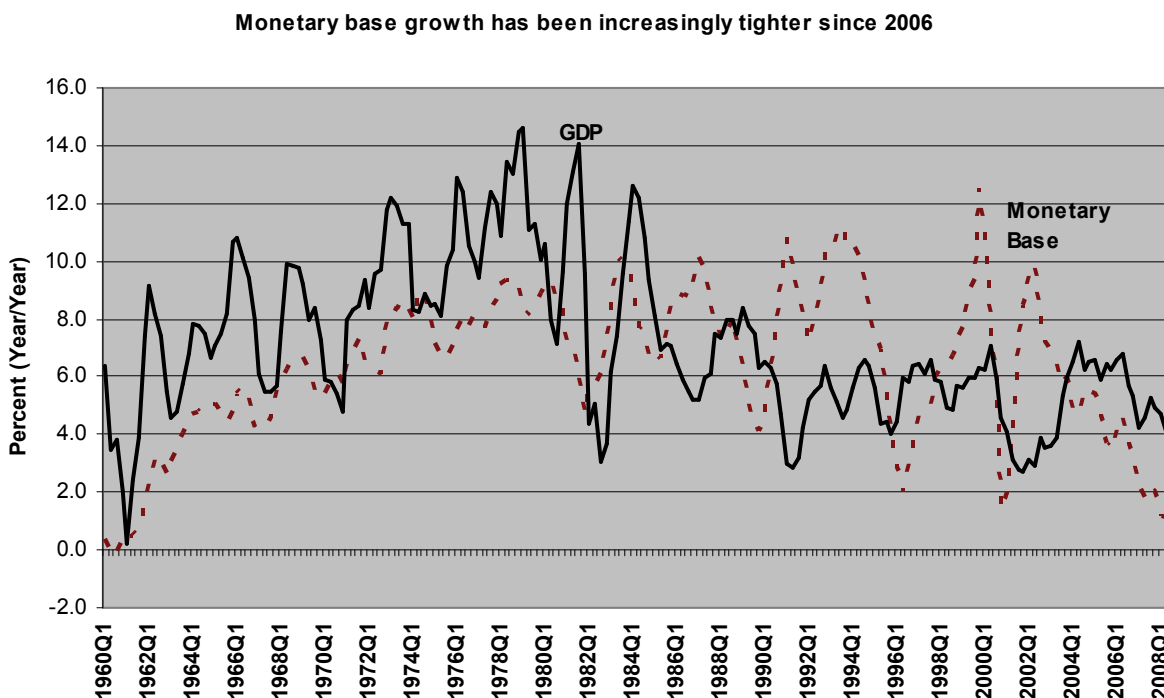
ment, and several financial institutions, mainly investment banks and not commercial banks, failed. This was well after the recession actually began and so is a poor culprit for the cause of the latest recession. Perhaps the latest worsening of the financial crisis is a cause of recession, however, and will extend the current one, caused by other factors well into the future. On the other hand, other factors that might account for the recession, or even factors related to the financial crisis, could portend the imminent end to the current recession.

Did the Federal Reserve cause the recession?

A leading candidate for the cause of the current recession is the Federal Reserve (Fed). The Fed has caused every post-world war II recession, according to most experts, especially Milton Friedman. For example, this conclusion is explained in the leading college money and banking textbook, Mishkin (2004). According to this view, every recession over the period has been associated with a sharp slowing in money growth and every sharp slowing in money growth has been followed or accompanied by recession. The latest recession is no different. In late 2006 there already were signs of a sharp slowing in money growth in place portending recession; see Tatom (2006). This slowing only got worse and lasted until September 2008. The foreclosure crisis was reinforced by the slowing in money growth that also ended the rapid appreciation which investors had counted on to make their housing investments profitable. Moreover, monetary slowing also tightened credit growth for housing purchases, making it more difficult for existing owners to refinance and for new purchasers to obtain credit to buy houses.

Figure 1 shows the growth rate of the Federal Reserve Board of Governors' measure of the monetary base, adjusted for reserve requirement changes, since 1960 along with the growth rate of nominal gross domestic product (GDP). The adjusted monetary base is the purest measure of the

Figure 1
Monetary growth has slowed sharply



Source: Federal Reserve Bank of St. Louis

Fed’s influence on the stock of money in the economy. It consists of the currency and financial institutions’ reserves. Both growth rates are measured over four quarter periods or year-over-year. The general picture is that the monetary base slows before or during every major slowing in GDP.

The monetary base has been slowing since mid-2002, but the tightening became most noticeable in 2006 and subsequently when the pace of growth began to slow to the lowest rates observed since the early 1960s.

The slowing continued until monetary base growth reached a mere 1.1 percent rate of growth in the second quarter of 2008. The growth rate of other monetary aggregates shows the same slowing. The measure of money used for purchases of goods, services and assets, called M1, adjusted for sweep balances that would have otherwise been held in M1, slowed from over 8 percent in 2004 to about 2.5 percent in most of 2005 and has been

below 2 percent in 2007-08, until the third quarter of 2008. The pace of M1 growth has been the slowest since the slowing that caused the 1990-91 and 1960-61 recessions. The figure shows that monetary base growth accelerated in the third quarter of 2008, but all of this increase came in the last two weeks of the quarter when the Fed began to aggressively increase its total assets. Since early September 2008, the Fed has more than doubled its total assets and the monetary base in an effort to boost total credit in the economy.

Note that monetary base growth continued to slow from an already recessionary pace during the first year of the financial crisis that began in August 2007, despite Fed rhetoric that it was attempting to stimulate the economy by lowering the federal funds rate target and by unprecedented private credit provisions. Unfortunately those provisions came at the expense of the credit the Fed provides to the federal government through purchases of government securities.

The slowing in nominal GDP growth began in late 2006 when it was about 6.8 percent and fell to 3.4 percent in the third quarter of 2008. Real GDP growth follows a similar slowing pattern (not shown). A key feature of Figure 1 is that monetary base growth has finally accelerated. With a lead of two to three quarters, given the size of the recent surge in money growth, nominal and real GDP growth can be expected to accelerate, ignoring other factors that might deepen and lengthen the recession. To the extent that the recession is largely due to monetary policy, it should end soon if the Fed continues to pursue the rapid monetary growth that it began in September 2008.

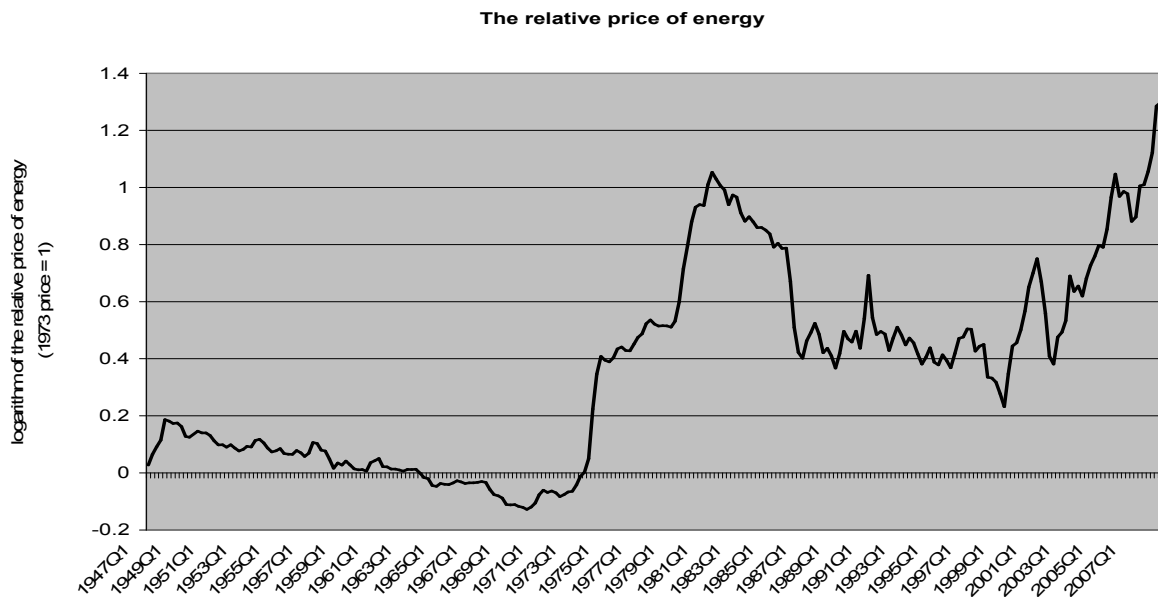
An oil price shock worsened the recession

The recent recession has also been influenced by sharp increase in oil prices in 2007-08 that raised the relative price of energy. Figure 2 shows an index of the relative price of energy constructed as the logarithm of the producer price index for fuel power and related products deflated by the personal consumption expenditure deflator and set to one in 1973. The vertical measure equals the continuous percentage change since 1973 and vertical measures are comparable. The relative price

of energy has been rising generally since early 1999, but there have been intermittent periods of significant decline. From the end of 2006 to the third quarter of 2008, the relative price of energy rose 41.6 percent. This can be compared with a 54 percent rise over the nine quarter period I/1979-II/1981, which played a significant role in the 1980 and 1981-82 recessions. The first energy price shock, which was associated with the 1973-75 recession, was closer in magnitude, but occurred much more quickly; the relative price of energy rose 40.6 percent from III/1973 to III/1974.

The energy price shock is a likely culprit for the recent recession, but there are some major qualifications. First, the surge in energy prices in 2007 came on the heels of a significant decline in 2006 so that energy prices were less than one percent higher at the end of 2007 than they had been at the end of 2005, despite a 17.5 percent rise in 2006. The swing in prices, as well as the size of the increase in 2007, suggested that energy prices were not contributing to a recession up until that time (see Tatom 2008). Over the next two quarters, however, energy prices continued to surge, rising another 23 percent, a pace that was clearly

Figure 2
Energy prices surged temporarily in 2007-08



Source: Bureau of Labor Statistics

recessionary in earlier episodes. Thus, energy prices would not have likely caused the recession that began in late 2007, but it did make it worse or deeper, and it very likely lengthened it.

What is not shown in Figure 2 is that oil and energy prices have fallen sharply since their peaks in July 2008. By October, energy prices had returned to their level at the end of 2007 and further reductions are certain to wipe out most of the rise in energy prices since the end of 2003. Thus, like the monetary policy influence, the energy price shock influence on the recession is in the process of rapidly disappearing and reversing.

An earlier parallel for a sharp run up and then decline in oil prices occurred in 1990. When Iraq invaded Kuwait in August 1990, oil and energy prices spiked up, with oil prices actually rising 154.9 percent from July to October 1990. Subsequently, oil prices fell back 54.2 percent so that by March 1991, the business cycle trough month, oil prices were only 16 percent higher than before the invasion. So it took an oil price reversal for only 5 months from October to March to end the recession. Oil prices are falling faster in the current recession from their peak in July 2008.

The 1990-91 energy price shock was the first on many episodes that are relevant for energy price shocks since then. In the 1970s and 1980s, major energy price shocks were permanent, in the sense that they did not quickly reverse. If prices rose

sharply (1973-74 and 1979-81), they did not fall off as sharply and immediately. If energy prices fell sharply (1986), they did not rebound immediately and as much. Since the mid-1990s there have been several episodes of sharp increases and decreases in energy prices, generally larger than 20 percent in absolute value and lasting usually one to two years. In other words, large enough to have noticeable effects on output and inflation, but not usually fully permanent. The table shows these periods drawn from Figure 2.

When will the current recession end?

The perspective here is optimistic. If the Fed caused the current recession and energy prices made it worse and longer, *and* if there were no other factors influencing it, then a quick end could be in sight, in the first or second quarter of 2009. In the first instance, the recession would match the length of the longest post-world war II recessions in 1973-75 and 1981-82 recessions. However, the influence of the financial crisis has not been taken into account. So far there is no strong evidence that credit has declined more than monetary policy alone might suggest. Nor has there been deterioration on the equity of the banking system that might induce a deleveraging process as significant as many analysts have suggested. If financial conditions deteriorate substantially, however, despite the Fed's dramatic actions from September 2008 to December 2008, then the recession that has had other causes so far would take on a new character.

Table
Major Moves in energy prices: 1997-2008

Period length	Period	Percent change*
2 years	I/1997-I/1999	-27.1%
2 years	I/1999-I/2001	51.9
1 year	I/2001-I/2002	-37.0
1 year	I/2002-I/2003	31.0
3 quarters	I/2003-IV/2003	-7.1
2 years	IV/2003-IV/2005	42.8
1 year	IV/2005-IV/2006	-16.7
7 quarters	IV/2006-III/2008	41.6

Even in the best case, that the economy follows a pattern somewhat similar to the end of the 1990-91 recession, one should keep in mind that, while the recession ended in March 1991, the recovery was slow, so slow that it was referred to as the “jobless recovery.” From the first quarter of 1991 to the third quarter of 1992, the growth rate of real GDP was only 3.1 percent, relatively low for the first six quarters following a recession. The unemployment rate of 6.8 percent at the end of the recession in March 1991 actually rose to 7.8 percent 15 months later in July 1992.

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- John A. Tatom is the Director of Research at Networks Financial Institute.

Global Responses to the Financial Crisis Continue

By Martha McCormick

martha.mccormick@isunetworks.org

November 2008’s *Research Buzz* included discussion of the Group of Twenty (G-20) Communiqué regarding its November 15, 2008 meeting in response to the current financial and credit crisis. This article considers ongoing responses from a variety of other global organizations and players, in further response to the crisis, and the attempts to address the problems brought into focus as a result of the ’08 financial turmoil.

One notable development has been the leading role of the European Union (EU), and specifically French President Nicolas Sarkozy, though it must be said that Sarkozy’s approach and proposals have put him somewhat at odds with other EU nations in seeking solutions. His term of EU Council President expires at the end of December 2008, however. Like many of the responses internationally, EU officials target weak credit rating processes and oversight as a major culprit in the current crisis. In late October 2008, the EU drafted a law requiring rating agencies to make public their working methods and to follow new rules on employee pay and limits on the duration of client relationships. The concern is that leading credit rating agencies, such as Moody’s, Standard & Poor’s and Fitch, are being paid by the very companies whose creditworthiness they are charged with assessing, leading to overly favorable credit ratings. The proposed legislation authorizes the Committee of European Securities Legislators to coordinate rating agency oversight and supervision.¹

While initially President Sarkozy was seen as nimble and responsive to the crisis, he has come under fire for hyperactively proposing too many new programs in rejoinder to the unfolding crisis. His actions inside France include new subsidized work contracts, a loosening of France’s famed workweek restrictions, and warnings against “unjustified” employee layoffs. In the greater EU context, Sarkozy is perceived to be pressuring both

the European Central Bank and European Commission regarding their control of the “euro-zone economy.”² Other EU nations fear that Sarkozy is motivated by a desire to skirt EU restrictions on the size of France’s budget deficit so that he can stimulate his nation’s economy out of recession. German chancellor Angela Merkel resents Sarkozy’s lack of consultations with other EU leaders, his last-minute notice of several summit meetings, and his pressure on the European Central Bank. Sarkozy has also been widely criticized for two proposals: first, the establishment of an EU sovereign fund for shoring up businesses whose stock values have dropped dramatically and, second, an EU “unified economic government” bringing together heads of state, and not just finance ministers.³

After the G-20 mid-November 2008 meeting, Sarkozy spoke aggressively about taming American capitalist impulses and announced plans to host his own January 8-9, 2009 summit (to be co-hosted by former British prime minister Tony Blair) that appears to compete with the G-20 summit meeting planned for April 2009. He did not allude to such plans for a French-hosted summit while at the G-20 meeting itself. The “surfeit of summit meetings reflects what has become a tense trans-Atlantic contest over the global economy,” reports the *New York Times*. Europe wants a “long-overdue discussion of the excesses of American-style capitalism” at a time when the U.S. has a lame duck presidency that is determined to prevent European domination of international financial regulation. The timing of the proposed Paris meeting pre-dates the inauguration of Barack Obama as the next U.S. president, whereas the scheduled April ’09 G-20 meeting allows for the new Obama administration to get on its feet before policy responses are further tackled by the G-20.⁴

Other, less-controversial European responses to global credit crises include a Swiss National Bank move to better measure bank soundness through an imposition of tighter leverage ratios, as opposed to looser EU reliance on Tier 1 capital ratios based on risk-weighted capital, which some market participants blame for masking bank soundness problems, including at UBS. The leverage ratio, “a measure of a bank’s Tier 1 capital to average tangible assets,” has become an increasingly important ana-

lytical tool for measuring bank soundness.⁵ The higher a bank’s Tier 1 leverage ratio, the lower the bank’s leverage. U.S. banks have a Tier 1 leverage ratio of 5.5 to 6%, while Credit Suisse comes in at 3.4%, UBS at 2.7%, and Deutsche Bank at 2.4%. European regulators typically focus on Tier 1 capital ratios, whereas the Swiss regulator in November 2008 was proposing a move to a capped leverage ratio.⁶ The Centre for European Policy Studies claims that European focus on risk-weighted capital ratios disguised solvency problems such as those at Belgian bank Dexia. While Credit Suisse initially argued against the proposed capped leverage ratios, it has since reached an undisclosed agreement with the Swiss regulator on leverage ratio caps, whereas UBS has agreed philosophically with the project but has yet to agree with the Swiss regulator on specifics. In contrast to European regulators, the U.S. uses at least three measures to analyze bank soundness: 1) Tier 1 capital divided by risk-weighted assets, 2) total capital divided by risk-weighted assets and 3) Tier 1 capital divided by total assets. It is the latter that are more constraining under U.S. “prompt corrective action” standards and that are not followed in Europe. While the U.S. approach has proved “more durable,” some argue for the inclusion of all securitizations on bank balance sheets for the most robust measure of bank soundness.⁷

Headquartered in Switzerland, the Bank for International Settlements (BIS), an international organization fostering monetary and financial cooperation and serving as a bank for central banks, works jointly with the Basel Committee on Banking Supervision to run the Financial Stability Institute, promoting sound supervisory standards and practices around the globe. On November 20, 2008, the Basel Committee announced a “comprehensive strategy to address the fundamental weaknesses revealed by the financial market crisis related to the regulation, supervision and risk management of internationally-active banks.”⁸

The key building blocks of the Committee’s strategy are the following:

- strengthening the risk capture of the Basel II framework (in particular for trading book and off-balance sheet exposures);

- enhancing the quality of Tier 1 capital;
- building additional shock absorbers into the capital framework that can be drawn upon during periods of stress and dampen procyclicality;
- evaluating the need to supplement risk-based measures with simple gross measures of exposure in both prudential and risk management frameworks to help contain leverage in the banking system;
- strengthening supervisory frameworks to assess funding liquidity at cross-border banks;
- leveraging Basel II to strengthen risk management and governance practices at banks;
- strengthening counterparty credit risk capital, risk management and disclosure at banks; and
- promoting globally coordinated supervisory follow-up exercises to ensure implementation of supervisory and industry sound principles.⁹

Nout Wellink, Basel Committee Chairperson, lists the objectives of these strategies as strengthening of capital buffers, containment of leverage, and improved risk management and governance practices. In addition, the Committee has issued, in November and December '08, additional guidance for assessing banks' financial instrument fair value practices and a study of audit quality and failures with recommendations for improved accounting standards and increased transparency of financial instruments.¹⁰

Meanwhile, within the U.S., one sector of enhanced activity in light of market turmoil is the response of the Securities and Exchange Commission (SEC) and its chairman Christopher Cox pertaining to short selling, derivatives regulation, and credit rating, the same issue highlighted in the European context. The SEC has publicly identified a series of actions under the following general headings:

- Aggressively combating fraud and market manipulation through enforcement actions;
- Taking swift action to stabilize financial markets; and
- Enhancing transparency in financial disclosure.¹¹

In November 2008, Cox convened the International Organization of Securities Commissions (IOSCO) Technical Committee to consider:

- **Short Selling** — Consider the effectiveness of recent regulatory responses in reducing manipulative short selling without stifling legitimate short selling activity, and explore possible coordination on rules relating to naked short sales, in particular with regard to position reporting and delivery and pre-borrowing requirements
- **Under-Regulated or Unregulated Products** — Develop disclosure principles to promote transparency in OTC markets for derivatives and other financial instruments which will contribute to enhanced investor protection and mitigating systemic risk.
- **Credit Rating Agencies** — Assess members' progress in adopting rules based on IOSCO's revised Code of Conduct, and accelerate work on developing a common examination module.
- **International Accounting Standards** — Ensure that the process of developing international accounting standards continues to take account of the interests of investors.¹²

In early December 2008, the SEC approved a series of measures for increased accountability and transparency in credit rating agencies, more meaningful credit ratings, and greater disclosure for purposes of protecting investors. Faulting credit rating agencies for their inflated valuations of residential mortgage-backed securities and of collateralized debt obligations, the SEC imposed additional regulatory requirements on credit rating agencies and imposed additional measures enhancing transparency of and competition among credit rating agencies. They did so under the authority granted the SEC by the Credit Rating Agency Reform Act; these new rules supplement a series of improved rules issued in June 2007. These Final Rules and Proposed Rules relating to Nationally Recognized Statistical Rating Organizations (NRSROs) and credit ratings are summarized in a fact sheet issued by the SEC on December 3, 2008.¹³

On December 1, 2008, Treasury Secretary Henry Paulson issued a recap of major Treasury and other governmental actions to date to shore up the financial system. These include:

- \$250 billion dedicated to increasing the capital of U.S. banks.
- Treasury has purchased preferred shares in 52 institutions, putting \$150 billion in additional capital into the financial system.
- The Federal Reserve and the Treasury inaugurated an aggressive, non-bank financial sector program to support the normalization of credit markets and the availability of affordable consumer credit to support economic recovery.
- Treasury will provide \$20 billion in Troubled Assets Relief Program (TARP) resources to back a Federal Reserve facility that will provide liquidity to issuers of consumer asset backed paper.
- Government-sponsored enterprises (GSEs) announced in November 2008 a 90-day moratorium on mortgage foreclosures.¹⁴

In total, regulatory and national governmental bodies are forced into making myriad responses and proposals to address the multiple sins that have combined to create the perfect storm of the current credit crisis and financial market turmoil. National ideologies and regional agendas, as well as fiscal and philosophical differences of approach of varying major markets around the world, have come into sharp relief as nations struggle to right their economic ships of state. While the U.S. hovers between the conclusion of one presidential administration and the launching of its next, final approval of many proposed legislative and regulatory remedies are pending, both in this nation and abroad.

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2. Erlanger 2008.
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4. Landler 2008.
5. Schultes 2008.
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8. Basel Committee on Banking Supervision 2008a.
9. Basel Committee on Banking Supervision 2008a.
10. See Basel Committee on Banking Supervision 2008b, 2008c.

11. See U.S. Securities and Exchange Commission 2008b for an enumeration of steps under each of these categories.
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- Martha McCormick is the Research Coordinator at Networks Financial Institute.

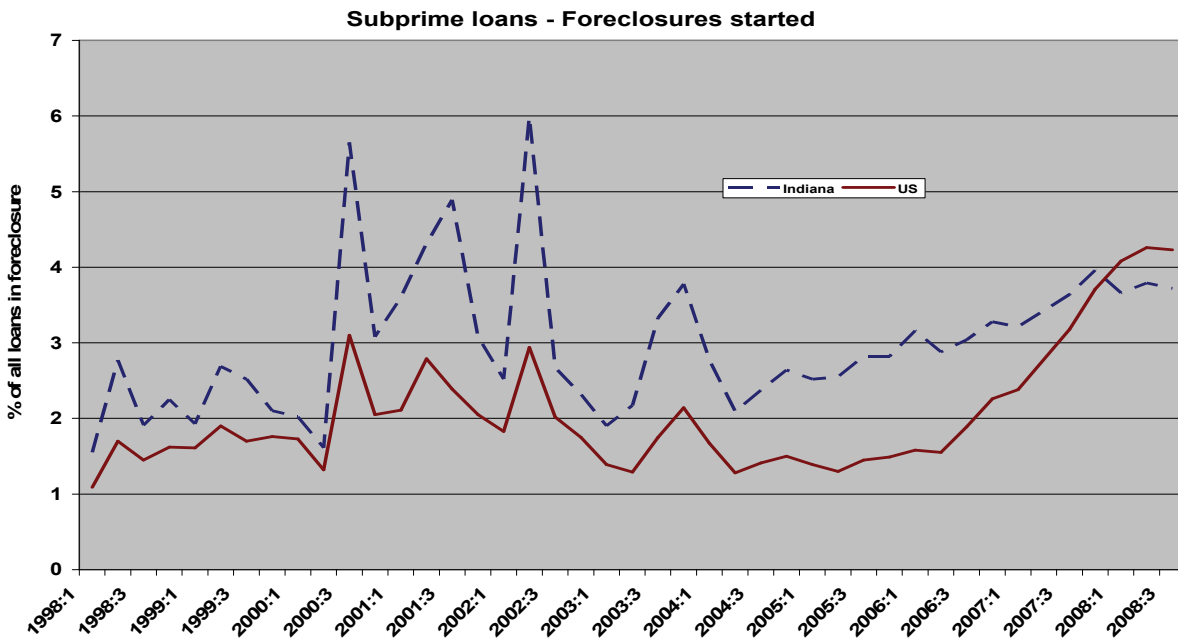
Indiana Mortgage Data Worsens, Rankings Improve

By Nick Ochieng
nick.ochieng@isunetworks.org

The Mortgage Bankers Association (MBA), on December 5, 2008, released the National Delinquency Survey results for the third quarter of 2008. Indiana's were little changed from the last quarter, with delinquencies rising, foreclosure inventory static and foreclosure starts dropping slightly.

Foreclosure inventory in Indiana stood at 3.59 percent of all loans outstanding, which was similar to the second quarter, also at 3.59 percent. Eleven states recorded foreclosure inventories above the national level of 2.97 percent, with Indiana's rank improving to sixth place from second a year earlier. Subprime foreclosure inventory is now at 12 percent of such loans outstanding, up from 10.29 percent a year ago. In spite of this, Indiana's subprime inventory rankings improved from fourth position in the third quarter of 2007 to fifteenth currently because of the worsening foreclosure experience elsewhere.

Chart 1



Source: Mortgage Bankers Association

Foreclosure starts have shown signs of improvement in Indiana over the past year. The third quarter of 2008 saw housing foreclosure starts slightly decline to 1.12 percent from 1.19 percent a year earlier. Nine states recorded foreclosures starts higher than the national average of 1.07 percent, with Indiana ranking eighth, compared to a dismal second this time last year. Subprime foreclosure starts show a similar trend for Indiana, improving to eighteenth place from the tenth position a year earlier. This improvement in subprime foreclosure starts, as shown in Chart 1, enhances a trend that began in 2008Q1 where Indiana rates have, for the first time in a decade, been lower than the national average.

While the Indiana ranking looks positive in comparison to other states, this is deceptive. The data show that subprime foreclosure starts continue to rise, though slightly. Whereas subprime foreclosure starts were at 3.64 percent a year ago, they are currently at 3.72 percent. Indiana's total delinquencies rose more rapidly from 7.91 of all loans in the last quarter to 9.31 percent, and it retained its fourth position nationally. Table 1 summarizes foreclosure rates for Indiana and the U.S.

The National Bureau of Economic Research recently officially determined that the U.S. has been in a recession since December 2007. A

continued downturn in the economic situation may suggest worse delinquency data in the coming months. In releasing the survey results, Jay Brinkmann, MBA Chief Economist and Senior Vice President for Research and Economics, paints a gloomy forecast for 2009 and notes that, "Absent a recession, the 2009 foreclosure number would likely have fallen by several hundred thousand but the effects of job losses and general economic deterioration make the 2009 outlook worse, particularly if mortgage problems become more widespread." While earlier increases in foreclosure activity in states like California and Florida have been attributed to speculation, weak underwriting and too many houses, continued recessionary effects such as large job losses are likely to increase home delinquencies.

To stem the surge in foreclosures, various measures are being taken. On November 11, 2008, the Federal Housing Finance Agency (FHFA), which regulates Fannie Mae, Freddie Mac and the Federal Home Loan Banks, announced the establishment of a streamlined loan modification program designed to reduce preventable foreclosures. Fannie and Freddie own or guarantee about 58 percent of all single family mortgages. Beneficiaries of this program will be borrowers who have missed three payments or more, own and occupy the property as a primary residence, and have not filed for

Table 1

Indiana and U.S. foreclosures in the third quarter of 2008

	Foreclosure rate	Loans serviced	Loans in foreclosure	Percent of loans serviced	Percent of foreclosed loans
Indiana					
Prime	1.96	591,954	11,602	69.0	38.5
Subprime	12.00	112,082	13,450	13.1	44.6
FHA	3.83	132,689	5,082	15.5	16.9
All loans	3.59	857,971	30,134	100.0	100.0
United States					
Prime	1.58	35,107,616	554,700	77.2	41.1
Subprime	12.55	5,494,365	689,543	12.1	51.1
FHA	2.32	3,752,778	87,064	8.3	6.4
All loans	2.97	45,474,524	1,350,593	100.0	100.0

Source: Mortgage Bankers Association

bankruptcy. The program creates a fast-track method of getting troubled borrowers to an affordable monthly payment where the first mortgage payment, including homeowner association dues, are no more than 38 percent of the household's monthly gross income. This affordable payment is expected to be achieved through a mix of reducing the mortgage interest rate, extending the life of the loan or even deferring payment on part of the principal. To encourage participation, servicers will receive a fixed payment of \$800 for each loan modified through this program. While Fannie and Freddie's mortgages only represent approximately 20 percent of serious delinquencies, FHFA hopes that with the strong partnerships participating in this modification program (Department of Treasury, Federal Housing Authority, HOPE NOW and its 27 servicer partners), other mortgage loan providers will get on board and adopt this program. Implementation of this program is expected to begin on December 15, 2008.

To get some families through this holiday season, Fannie Mae and Freddie Mac also announced a moratorium on foreclosures for the period beginning November 26, 2008 through January 9, 2009. Conditions for eligibility are, however, restrictive and few households may benefit. Homeowners must be 90 days or more late in their mortgage payments, owe at least 90% of their home's current value, live in the home on which the mortgage was taken and must not have filed for bankruptcy. Fannie Mae expects 10,000 to benefit from this while Freddie Mac projects 6,000. This may temporarily drive down 2008Q4 foreclosure numbers but may trend upwards thereafter upon expiry of the moratorium.

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- Nick Ochieng is a Research Associate at Networks Financial Institute.