How Will The US Economy Recover?

You would probably have to have been living on a remote desert island for the better part of two years to not see any signs of the slowdown in the economy of the United States. Since August of 2007, the real estate market has been reeling from plummeting house prices, due primarily to increasing defaults on sub-prime mortgages. While these mortgages were issued to millions of borrowers with patchy or relatively poor credit ratings over the past several years, interest rates remained unusually low before the Federal Reserve began to increase rates over 2005-2006.

Up until late 2006, this process was self-reinforcing, mainly due to the delayed impacts of interest rate changes, not to mention encouraging profits for lenders, who would often repackage the loans into securities which could be sold to investors globally. Many analysts called it a new era in risk management, justifying the arcane nature of many of these new investment entities with ever-larger profits.

But just as higher interest rates began to take their deflationary effects on the larger economy, millions of sub-prime mortgages began to reset, their rates immediately dependent on available credit. Moreover, many borrowers were not made aware of the insidious nature of their home loans.

Often, their interest rates are artificially low for some period of time, usually one to two years, and then change to reflect market rates afterward. These "teaser" rates were designed to lure more potential homeowners, and they worked: all estimates of the amount of sub-prime mortgages number in the millions, and many consumer advocacy groups have decried the skyrocketing incidence of "predatory loaning" leading up to the credit crunch. Defaults have continued to increase, which has forced the financial institutions which invested in mortgage-backed securities to write down billions, eventually leading to the spectacular collapse earlier this year of Bear Stearns, formerly Wall Street's fifth-largest investment bank.

Since the securities made from these increasingly worthless mortgages have been so widespread, any effort towards recovery must first be focused on stabilizing borrowers, who are increasingly behind on payments. In this respect, the government has taken several different courses of action. In an effort to stop unnecessary foreclosures, the US Treasury has begun an initiative to freeze mortgage payments at current levels for qualified recipients. However, its restrictions make less than 5% of homeowners eligible for the program.

In addition, the Treasury has introduced a plan to reorganize and regulate the lending industry over the next several years, which should help streamline the financial system in the future. However, its greatest effect so far has been to distract from more immediate economic problems.

By far, the greatest player in the recovery effort has been the Federal Reserve, which reversed its previously hawkish view to drop mortgage interest rates multiple times, from 5.25% last summer to 2.25% now, with a further cut of 25 basis points highly likely at the next meeting. They have also taken the unprecedented move of making its "discount window" rate loans available to investment banks. This access has historically only been available for commercial banks up until this point as a matter of last resort, but by bailing out Bear Stearns, the Fed made a commitment to help troubled investment banks weather the credit crisis. A recovery will require a combination of liberal monetary policy, further government intervention on behalf of mortgage holders, and enforceable regulation in order to prevent another bubble.

About the Author

Ki is a real estate agent in Austin Texas. He runs a site filled with information about Austin real estate. His site a search of the Austin MLS.

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