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Housing, Global Finance and American Hegemony: Building Conservative Politics One Brick at a Time

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Abstract:

How did US housing markets articulate both with global financial flows and US domestic politics? During the long 1990s, the US economy benefited from a system of global financial arbitrage in which the US economy as a whole borrowed short term, at low interest rates, from the rest of the world, while lending back long term at higher. A temporarily self sustaining housing market boom in the US based on declining nominal interest rates emerged from these flows. This boom favored employment and GDP growth in the US at the expense of some but not all advanced economies. The more that housing market financial structures in an economy approximated those in the US (widespread homeownership, high levels of mortgage debt to GDP, low transaction costs for

mortgage refinance, and mortgage loan securitization), the better that economy performed in GDP and employment terms during the 1990s. While falling interest rates could have benefited all economies, US style housing markets proved better at translating disinflation into new aggregate demand. This situation consolidates voter preferences around a continued low inflation environment, continuation of US financial arbitrage, and maintenance of high housing prices.

Housing, Global Finance and American Hegemony: Building Conservative Politics One Brick at a Time

How did the global housing boom and bust affect domestic politics in different countries, and what role did capital flows into and out of the US play in both the boom/bust and this new politics? This article provides an international context both for US domestic housing developments and the essentially domestic point of view in the other articles. The international context matters for three reasons. First, the US housing finance system was one of a few crucial conduits for the international capital flows that drove down the nominal cost of borrowing globally over the past 20 years. Second, because housing finance systems differ across countries, declining nominal interest rates differentially stimulated growth across the developed countries. Third, the politics of housing is closely connected to the politics of US ‘hegemony’ by creating a more market friendly domestic politics globally. These are different but overlapping phenomena.

There are thus three parts to this argument. Section one argues that the US operated a system of financial arbitrage at the global level 1991-2005. The US

systematically borrowed short term at low interest rates from the rest of the world and then invested back into the rest of the world long-term for a higher return. Arbitrage worked because the liquidity created by the US Federal Reserve system flowed back into US dollar denominated instruments that set benchmark interest rates for mortgages, while capital flows from the US flowed into instruments that did not affect benchmark rates. Housing finance markets linked the system of claims on the future circulating in global financial markets to local political and economic behaviors that affect the security of those claims.

The second section shows how this system of arbitrage connected *differentially* to housing markets and thus produced heterogeneous outcomes with respect to employment and GDP gains over the past 20 years. Falling global nominal interest rates should have reflat all developed economies. But differences in housing finance markets caused markedly different employment and GDP gains across those nations. Those benefits have electoral consequences for incumbents and challengers who can claim credit for good outcomes. Consequently, politicians in political economies characterized by financial repression, rather than the US style financial free for all, began introducing some elements of the US housing finance system, particularly securitization of mortgages. Housing-led differential growth advantaged the US and similar economies, while creating political pressures to liberalize repressed financial systems.

The third section specifically considers the US housing politics case. US housing market developments produced a specific variety of the conservatizing politics found in the other cases. In the current conjuncture, housing markets induce people to prefer a politics hostile to inflation and increases in tax funded collective services. The current

housing market structure thus inclines the average voter towards a more conservative politics locally. Because micro-level behaviors and preferences limit what occurs at the macro-level they also affect global politics. To rework an old phrase, cheap mortgages are financing the trenches defending against new demands for social protection in the US and some other countries.

The central narrative message in this paper is that the disinflation of the 1990s combined with the operation of global capital markets to differentially produce increased aggregate demand in countries characterized by wide-spread homeownership, high levels of mortgage debt relative to GDP, easy refinance of those mortgages and mortgage securitization. In turn, this increased aggregate demand produced a self-fulfilling increase in employment and output that benefited politically critical cohorts in those countries. The increased housing costs those cohorts face gives them a stronger interest in cash income over collective social services and in keeping inflation, and thus nominal interest rates, low. Housing outcomes and the financial structures for housing thus have important political consequences.

Section one: US Arbitrage in Global Financial Markets

All politics are local, and real estate is even more local. Nevertheless, local housing markets in the US and some other countries are tightly connected to global capital markets. The usual literature on global financial markets sees them as a *constraint* on government policy and spending that might shelter people from the market, as in the typical argument that globalization constrains welfare state provision. This constraint limits politicians' ability to raise taxes. Other versions see financialization as a *constraint*

on the ‘real’ economy and particularly manufacturing, which then secondarily affects average people through the kind of employment they can obtain. This constraint operates through high real interest rates.

By contrast, this section argues that global capital flows in the 1990s and 2000s also created *opportunities* for growth, rather than just constraints on organizational or collective behavior. These opportunities in turn affected people’s behavior by providing a combination of incentives and disincentives towards additional consumption based on the specific housing market financial structures in which they found themselves. Put simply, during the long 1990s the US operated a huge system of financial arbitrage that led to above OECD average GDP and employment growth. While this process ultimately created new constraint via homeowners’ economic preferences and the subsequent housing bust, it shows that financialization does not only generate political constraints.

My starting point is a well known paradox: while the US has been a large net foreign debtor from the early 1990s, the US receives net positive international investment income. Removing eight zeros, in 2005 the US was like a private investor with debts totaling \$136,000 and investments worth only \$111,000, who somehow managed to pay out only \$4,541 on those debts while earning \$4,746 from her own investments, and thus received net income of \$205. While a smart individual plausibly could do this – indeed many do – it is implausible that at an economy-wide or global level all Americans are systematically better investors than everyone else. Instead, the US operated a global system of financial arbitrage to produce this odd outcome. Arbitrage occurs when an intermediary exploits price differences between similar commodities on two different markets, buying and selling that commodity at the same time. At the macro-economic

level, the US systematically borrowed short term, at low interest rates, from the rest of the world, and then turned around and invested back in the rest of the world in longer term, higher risk, higher return, active investment vehicles.

Space constraints prevent a detailed analysis of US global arbitrage.¹ But a simple breakdown of inward and outward foreign investment stocks presents the essentials. Table 1 disaggregates foreign investments into four broad categories: Foreign Direct Investment (using the US Department of Commerce 10 percent threshold for control), portfolio equity holdings (i.e passive holdings of equity below the 10 percent threshold for control), portfolio debt (i.e. bonds), and bank loans. Aside from the obvious large US net debt position, what emerges from this first cut is the long term versus short term distinction noted above.

Approximately three-fifths of US overseas assets take the form of foreign direct investment and holdings of equities ('stocks' in US parlance). These relatively active holdings have the potential for capital appreciation and for the capture of profits if firms are well managed. By contrast, almost over three-fifths of foreign investment in the US occurs as passive holdings of bonds and loans. Let us put aside one implication of this crude data, which is that at a macro-economic level the world subsidizes the global expansion of US corporate capital and financial intermediaries, in favor of a detailed examination of a second, important connection to mortgage markets.

INSERT TABLE 1 HERE

Fifty-nine percent of foreign investment in US bonds as of December 2005 occurred as purchases of US government and government guaranteed agency debt. At that time, foreign investors held 51.7 percent of outstanding marketable US Treasury securities and 14.1 percent of outstanding “agency” mortgage backed securities (MBS) debt (US Treasury, 2005, 13; US Treasury, 2007, 3, 5).² Agency debt refers to MBS originated by “Fannie Mae” – the Federal National Mortgage Agency – and “Freddie Mac” – the Federal Home Loan Mortgage Corporation. Outsized foreign holdings of Treasury and agency debt helped to drive down interest rates on US mortgages during the long 1990s. Current estimates suggest that recycling of Asian trade surpluses during the late 1990s and early 2000s depressed yields on 10 year US Treasury debt by about 90 basis points, or almost 1 percentage point, and as much as 150 basis points in 2005 (Warnock and Warnock, 2006). The interest rate on the 10 year Treasury bond serves as the reference rate or benchmark for nearly all US mortgages. Changing interest rates for T-bonds thus immediately affect interest rates on new mortgages.

Foreign purchases of agency debt from Fannie Mae and Freddie Mac have an even more direct effect. The US federal government created Fannie Mae in 1938 as a government agency that would make housing more affordable by nationalizing the flow of funds in the mortgage market. While Fannie Mae was privatized in 1968-70, the market behaves as if it has an implicit government bailout guarantee, because it is still considered a government sponsored enterprise (GSE).³ Savings and loan banks (i.e. the US version of *sparkassen* or building societies) got their own version of Fannie Mae, called Freddie Mac, in 1970; it was fully privatized in 1989. The market’s belief in an implicit government

guarantee gives Freddie Mac and Fannie Mae an advantageous position in their business, which is the creation of MBSs.

Fannie Mae essentially invented the MBS in 1981. Freddie Mac invented the CMO, collateralized mortgage obligation, a derivative that slices up principal and interest payments so that investors can buy bonds of varying maturities. CMOs and MBS are thus different flavours of the larger category of CDOs, or collateralized debt obligations, which includes receivables from car loans, student loans, credit cards and other forms of debt. Fannie Mae issues about 50 percent of US MBS, representing about 1.3 trillion in mortgages, and held a further \$0.8 trillion in its own portfolio as of year end 2003 (FNMA, 2003). Freddie Mac issues about 45 percent of US MBS, representing about \$1.6 trillion in mortgages at year end 2005 (Freddie Mac, 2005, 19). Fannie Mae and Freddie Mac are the pipe connecting international credit markets to the domestic US housing market via the sale of securitized mortgages.

Securitization allows banks to move mortgages off their books by selling those mortgages in the open market and thus refreshing their capital. Then banks can originate yet more loans while earning the bulk of their income from transaction fees. This contrasts with the older model in which banks held mortgages to maturity and made money off the interest rate spread between deposits and loans. Securitization shifts interest rate risk off banks' books and onto the buyer of the MBS or CMO. Fannie Mae and Freddie Mac are both intermediaries and principals in this process. They buy residential mortgages from original mortgage lenders (banks), pool and securitize those mortgages, and sell them directly or as derivatives to the secondary market. Pooling mortgages averages out the risks of default and pre-payment, creating a predictable stream of payments. In addition,

mortgages with similar risk characteristics can be packaged and sold at interest rates that reflect those risks. Securitization allows investors to buy a bond whose income stream is defined by the aggregated principal and interest payments made by individual home-buyers. The primary domestic purchasers of agency debt are insurance funds and pension plans seeking to offset predictable long term liabilities with equally predictable long term assets.

While foreign purchases of securitized agency debt are *relatively* lower than their purchases of Treasury debt, in terms of the total foreign share of outstanding securities, the *absolute* amounts are nearly identical because there is usually about twice as much agency debt in circulation than Treasury debt. Indeed, agency debt typically represents a full third of all marketable US debt securities, public and private, reflecting an increase in the aggregate value of US personal mortgage debt from roughly \$2.5 trillion in 1990 to about \$9.5 trillion in mid-2006 (Federal Reserve Bank). Foreign purchases thus directly depressed yields on US mortgages by lowering the reference rate for mortgages and by absorbing mortgages in the form of MBS. US arbitrage in global capital markets thus stimulated its domestic housing market by providing relatively low interest rates to existing home-owners wishing to refinance their mortgages and to new homebuyers.

Section 2: Differential Effects of Housing Market Financial Structures

Of course, US Treasury debt is the reference rate not only for the US market, but also for many global markets, including indirectly the Euro market. Why didn't foreign purchases of US Treasuries depress yields and lending rates in other countries, and thus redound to everyone's benefit? After all, long term nominal interest rates fell everywhere

in the 1990s, a period of profound disinflation. Euro-area long term interest rates fell from 11.2 percent in 1990 to 4.7 percent in 1999. US long term rates similarly fell from 8.7 percent to 4.0 percent 1990-2003, almost halving the average new mortgage interest rate (OECD 2005; JCHS, 2008, 36).

Disinflation and subsequently lower nominal interest rates should have increased aggregate demand everywhere, even if real interest rates remained high. But as disinflation filtered through different housing market finance systems it produced different degrees of increased aggregate demand and thus different employment gains. Put bluntly, the more housing was socialized and the more impediments there were to consumer access to housing-related credit, the smaller the aggregate demand ‘bang’ a given economy got from a ‘buck’ of disinflation. This is why the US system of global financial arbitrage largely benefited the US and those economies with similar housing market institutions. Housing market financial systems more like those in the US were better at translating 1990s disinflation into increased demand.⁴ Note that our point here is *not* that housing alone drove the US and other economies. Rather, differences in housing finance systems are associated with the *net* difference in growth rates. While all rich economies shared growth impulses from the internet boom, the supply chain revolution and the mobile telecoms revolution, only some rich economies also got growth from housing. Why?

Disinflation in the long 1990s could have released additional purchasing power as debtors’ interest payments potentially fell with falling nominal interest rates, and as consumers’ dollars went farther in goods markets. Yet disinflation had to be translated through housing finance market institutions into additional purchasing power. Countries

with housing finance markets most like those in the US received the greatest increment to purchasing power, causing rising employment through normal Keynesian multiplier mechanisms. Countries with housing finance market institutions least like those in the US, and which in addition stifled growth of aggregate demand through wage restraint, did not experience rising aggregate demand and employment. Countries with mixed institutions had mixed outcomes.

Four key features characterize US housing finance markets:

1. relatively high levels of private homeownership
2. relatively high levels of mortgage debt in relation to GDP
3. easy and relatively cheap refinance of mortgages as well as ‘cash out’ of home equity
4. securitization of mortgage loans

These four features enabled a relatively straightforward process of Keynesian demand stimulus to operate in the US economy in the late 1980s and even more so in the 1990s. As nominal interest rates fell, homeowners refinanced mortgages, shifting considerable purchasing power away from rentier interests and towards individuals with a higher propensity to consume goods, services and housing. This consumption in turn generated new employment through standard Keynesian multiplier effects, sustaining the expansion by helping shift the US federal budget into surplus and thus enabling the Federal Reserve to continue lowering interest rates.

Falling interest rates also ramified through liquid housing markets to create fictitious capital that also boosted employment and growth. Nominal interest rates matter for asset valuation. As nominal interest rates fell, the same nominal dollar income could

be used to service a larger and larger mortgage. People entering the housing market thus bid up housing prices because they could enjoy more ‘housing’ at the same monthly mortgage price. Much the same happened in equity markets. But retrospective analyses confirm that the release of home equity mattered much more than rising share markets for the net increase in real personal consumption in the OECD from 1996-2001, both because the propensity to consume new home equity is much higher than for rising capital gains, and because home equity bulks larger in the average person’s portfolio (Ludwig and Slok, 2002; Borio, 1995; Case, et al., 2001).

However, absent any easy way to tap home equity, this latent additional purchasing power remained exactly that: latent. This is why countries needed to combine widespread ownership with high levels of mortgage debt, easy refinance, and securitization.

Widespread ownership without mortgage debt, as in Italy, meant no way to reduce the carrying costs of housing and free up purchasing power. Widespread ownership with costly and difficult refinance meant that homeowners could not translate falling nominal interest rates into a smaller interest burden, as in France. Shallow homeownership and difficult refinance meant rentier interests prevailed over debtor consumption, as in Germany. No securitization inhibited banks’ willingness to refinance loans and thus pass disinflation along to consumers.

INSERT FIGURE 1 ABOUT HERE

INSERT TABLE 2 ABOUT HERE

INSERT TABLE 3 ABOUT HERE

Figure 1 and Tables 2 and 3 characterize most developed economies into winners and losers based on the degree to which those countries had US style housing markets and their employment and GDP growth in the 1990s. Figure 1 graphs the *relative* growth in absolute employment and GDP per capita. It does not graph absolute percentages changes in those two items, but rather, the degree in percentage terms by which a given country either *out-performed* or *under-performed* the average level of performance for the indicated countries. GDP per capita is used because it controls for the very different rates of population growth across these countries. Absolute employment is used because it captures job creation better than does the unemployment rate. Figure 1 shows an unsurprising but nonetheless meaningful correlation between employment performance and growth in GDP per capita. Countries that outperformed the OECD average on employment growth also typically outperformed on GDP growth, allowing us to categorize countries as growth winners or losers in the long 1990s.

Table 2 shows that GDP and employment gains were neither solely the consequence of financial manipulation nor solely about housing construction. Winners not only had above average growth for those two indicators, but also typically had even stronger above average increases in economy wide gross value added (GVA), manufacturing gross value added (GVA-M), gross fixed capital formation (GFCF), housing GFCF (GFCF-H), and GFCF in metals and manufacturing (GFCF-MM). While housing construction surely played a strong role in the winners' economic booms, in almost all of the winners the evolution of the absolute level of GFCF-H was smaller than

overall growth of GFCF, although in the US GFCF-H was relatively stronger than in many other countries, and definitely above historical norms in 2005-2006. Moreover, in most of the winners, the share of housing and all construction in GFCF fell; in the US for example it fell from roughly 65 percent of GFCF in 1991 to 49 percent in 2002. Housing had strong multiplier effects but was not the sole driver in the economy. Instead, the housing-led economy spurred outsized increases in real production and investment. In turn, this undoubtedly boosted productivity as throughput increased.

Table 3 characterizes countries using the four important housing market financial characteristics noted above. It creates a synthetic housing index to capture the degree to which a given housing finance market facilitates the translation of falling nominal interest rates into additional purchasing power. This index combines the rate of homeownership, the ratio of mortgage debt to GDP, the availability of home equity withdrawal, the level of transaction costs involved in mortgage refinance, and the degree to which mortgage securitization occurs. Table 3 also presents a synthetic index that combines the degree of deviation from the average evolution of per capita employment and GDP gains 1991-2005 – a kind of reverse misery or “un-misery” index. Figure 2 combines these two indices to relate graphically how housing market characteristics map onto employment and GDP gains. Figure 2 shows that countries with US style housing finance systems benefited with respect to employment and GDP growth relative to those without, and that the relationship is not random.

INSERT FIGURE 2 ABOUT HERE

The housing-growth connection was somewhat self-sustaining. In the absence of income and employment growth, a run up in housing prices is unlikely to have gone on for long. Rising prices would have quickly priced income-short buyers out of the market, leading to falling or stable prices. Instead, home equity withdrawal and refinance enabled consumers to increase their consumption across the board, generating faster employment and income growth. In turn, growth both validated housing prices, enabling lenders to advance ever larger mortgages, and it helped profitability in the rest of the economy, promoting job growth and a rising share market. A virtuous (but not eternally so) cycle of rising home prices, rising consumption, rising income and employment, and rising profitability drew in yet more foreign capital seeking assets with increasing values. Because foreign central banks as well as private entities channeled much of this investment into Treasury and Agency securities, this in turn reduced interest rates, providing a further boost to housing prices and aggregate demand. And this in turn further motivated investors in relatively slowly growing economies to continue to invest in other economies with housing booms. Once the US economy ran out of employment gains and potential new buyers in the 2000s, though, the boom turned to bust.

This section argued that the benefits of the 1990s disinflation were felt unevenly in the rich countries. While other factors surely also mattered, one important factor was the degree to which housing finance systems could translate falling nominal interest rates into increased aggregate demand and thus into increased employment and GDP. This increased demand was *not* solely housing related, but also deeply affected the core parts of the non-housing economy, including manufacturing. What consequences did the

housing boom have on individual interests and politics? This was the task set forward at the beginning of the paper, and it is to this task that we now turn.

The Old and New Politics of Homeownership

The current combination of historically low nominal interest rates, high rates of homeownership, and high, but falling, housing prices should incline core groups in the US voting public towards a preference for low inflation and low taxes. All other things being equal they will favor a more conservative politics benefiting long term creditor interests and groups with strong private incomes. Thus this section makes three related arguments: First, that in the abstract, private home-ownership produces a more conservative politics; second, that the current conjuncture makes these preferences even stronger; third, in the US, the core cadre that dominates electoral politics has a substantial economic interest in housing that meshes with a similar orientation in lower income groups. This core group, and similar groups in other countries, are the soldiers who man the trenches in defense of private incomes and against greater public spending. The ramparts of these trenches are the local governments and neighborhood associations these people dominate.

As noted in the introduction, the classic arguments about housing by Kemeny and Castles made a theoretical and an empirical case that widespread private homeownership inhibited a universal welfare state. Both agreed on a central premise about private homeownership: mortgages crowd out taxes. Kemeny argued that homeownership crowded housing expenses into the early part of a typical home-owner's life. Homeowners' need to accumulate a down payment and then to service a mortgage would

incline them against higher taxes for public services. Castles demonstrated a statistical link between high rates of homeownership in the first half of the 20th century and low rates of public pension provision, arguing that homeownership and larger pensions were functional equivalents. The current American housing market reinforces both Kemeny and Castles' dynamic while also inclining people against higher inflation and higher nominal interest rates.

Although the structure of the US housing market did not change much during the 1990s, conjunctural conditions did change. The US housing market, as noted above, is characterized by relative high levels of home ownership (generally over two-thirds of households), relatively easy mortgage refinance, relatively easy access to home equity, and widespread securitization of mortgages (Table 3). Transaction costs for mortgage refinance are low, generally around 1 percent of the principal, and are often capitalized into the mortgage. This means that US homebuyers can make a one way bet on mortgages by taking out a fixed rate mortgage. If rates rise, debtors are protected for the duration of what is typically a 30 year loan. If rates fall, debtors can take advantage of this by refinancing the mortgage at a new, lower rate, because most loans do not have pre-payment penalties. That said, marginal buyers, or those who anticipate having to move in the near future, often take out adjustable (variable) rate mortgages (ARMs) because the introductory rate on ARMS are often lower than for fixed rate mortgages, albeit higher after the inevitable rate reset. ARMS were not invented until the late 1970s and not widespread until the 1980s. Today they typically constitute 20-35 percent of new mortgage originations in any given year, up from about only 10 percent in the late 1990s,

though at the housing bubble's peak they constituted around half of new mortgage originations (Freddie Mac, 2005, 2).

By the same token, home equity – the difference between the house's market value and the residual mortgage principal – is easily (perhaps too easily) tapped in the US. Transaction costs are low – less than 1 percent and often waived for owners with substantial equity – and interest rates are generally the prime rate or LIBOR plus 1-2 percentage points. Because mortgage interest is tax deductible and because home equity loans are considered mortgages, households not only generally use home equity lines of credit (HELOCs) to finance home improvements but also cars, college and the retirement of (much more expensive) credit card debt (McConnell et al., 2003, 6). Americans' ability to do this kind of credit arbitrage encourages consumption.

Finally, the bulk of US mortgages are securitized. Up until the late 1990s this had beneficial effects, unless you were a bad credit, no/low down payment borrower. Fannie Mae set criteria for “conforming” loans that made them easier to package into an MBS: 30 year terms, 10-20 percent down payments (i.e. purchase money), household housing related debt payments no higher than 28 percent of gross income and total debt payments no higher than 36 percent of gross income. Banks in turn imposed these criteria on buyers, providing lower interest rates in return for a lower probability of default.

But by the late 1990s, new non-bank mortgage lenders began aggressively offering “Alt-A” and “sub-prime” mortgages to households with bad credit history, no or miniscule down payments, and quite high debt-to-income ratios. Not all this subprime lending went to poor households. Much also went to over-leveraged higher income groups. These mortgages accounted for 32 percent of all originations by 2005 (JCHS,

2008, 39). Banks packaged these risky mortgages into MBS and then tried to control for their inherent riskiness by pooling slices of these MBS as collateralized debt obligations (CDOs). Despite this, the subprime and Alt-A loans backing these MBS and CDOs began defaulting in large numbers in late 2007 as housing prices decelerated and buyers proved unable to either handle their housing payments or refinance their way into a lower interest rate prime mortgage.

INSERT TABLE 4 ABOUT HERE

Three households and the core of civil society

Let us consider three different American families – recent young homebuyers, a middle age household, and a near retirement age household – to show how the current conjuncture induces each to fear high inflation, higher nominal interest rates and higher taxes. Imagine a young family in their early 30s whose \$37,000 post tax income puts them in the middle quintile of the income distribution (US Bureau of Labor Statistics, 2004). Half of these families have bought a house (see Table 4). New home buyers in this group confronted a 90 percent increase in housing prices 2000-2006, which means they probably will be devoting approximately one-third to half of their income on mandatory housing related payments for mortgage principal and interest, taxes, and insurance (i.e. “PITI”). Overall, the middle 50 percent of the US income distribution devotes about 20 percent of total income to debt service, but over 10 percent of this

quintile faced housing payments in excess of 50 percent of their income in 2006 (Federal Reserve Bank; Fellows and Mabanta, 2007, 4-7, 13; JCHS, 2008, 40). This family precisely fits Kemeny's ideal type. With such a high proportion of income devoted to housing, this family will be hostile to additional tax burdens. This is even truer for households in the bottom quartile, with household incomes under \$22,000. There, 40 percent of households had a mortgage, and of these 42 percent had housing costs in excess of 50 percent of their income (JCHS, 2008, 40).

Rising inflation creates a triple threat to the financial security of this family, particularly if they have an ARM (variable rate mortgage). First, inflation increases the nominal interest rate on their variable rate loan. While inflation also erodes somewhat the long term cost of carrying that loan, the change in PITI payments triggered by upward interest rate adjustments subjects this family to immediate financial stress. Second, a rising interest rate also puts downward pressure on housing prices. The price of a house, like any other asset, now rises and falls as interest rates change. Rising interest rates press down on the market price of houses by increasing the monthly payment of any potential new homebuyer. So our family might join the roughly 20 percent of US homeowners who now have negative equity. Finally inflation running ahead of wage increases erodes our family's living standard.

Our middle aged homeowner household is likely to have a somewhat higher income at around \$50,000 or \$55,000, and have somewhat higher equity in their house. But they probably also have chosen to extract that equity from their house through a Home Equity Line of Credit (HELOC) (US Bureau of Labor Statistics, 2004). HELOCs are effectively a second mortgage secured on the owner's equity. Approximately one-

fourth of US homeowners have a HELOC or similar debt, and this is surely more prevalent among our middle aged homeowners than the younger ones, who typically have little equity with which to secure a HELOC. Americans extracted about \$1.2 trillion in home equity from 2001-2004, or about one-fifth of the rise in home prices (Greenspan and Kennedy, 2005). They used one third of this to retire more expensive non-housing debt like credit card balances. By 2004 HELOC debt accounted for one fifth of all debt secured against primary residences (Federal Reserve Bank). About one fourth of this group faced housing related costs in excess of 30 percent of their income in 2006 (JCHS, 2008, 40).

HELOCs are typically ARMs, making this family vulnerable to interest rate increases, though probably less so than the younger family. Like the younger family, they are also vulnerable to declining home prices if they cashed out substantial amounts of home equity. And they are vulnerable to other owners' defaults in their own local market. Even if they haven't already taken out a HELOC, the widespread use of HELOCs to finance college tuition for children makes owners sensitive to home price fluctuations. The salience of HELOCs is visible in the steady decline in total aggregate equity for all homeowners with mortgages.

What about our older homeowners? By age 65, about 70 percent have paid off their mortgage. While their greater dependence on Social Security for cash income – the public old age pension, accounting for 40 percent of income for people over age 65 – might incline them to prefer higher taxes and larger public incomes, their housing situation also gives them reasons to resist taxes and inflation. The elderly's primary store of wealth is their house; over 70 percent of households aged 65 and over own their house.

This group increasingly captures that housing equity through reverse mortgages or uses outright sale to finance care in assisted living or a nursing home. By age 75 the percentage of homeowners drops down to about 70 percent, indicating liquidation of this asset. Politically, this group is likely to be less sensitive to inflation and more sensitive to rising taxes, particularly property taxes, as their incomes are often fixed.

INSERT TABLE FIVE ABOUT HERE

Indeed, the run up in housing prices has probably made all of our groups hostile to rising taxes (Wilson, 2006). Higher housing prices mean higher property taxes (i.e. ‘rates’), which squeeze other revenue sources. In the US, property taxes are fundamentally a local revenue source that pays for education, policing and some social services. They provide roughly 70 percent of local government revenues and 10 percent of all tax revenue. Their dollar volume increased at twice the rate of all taxes 2000-2005 (OECD database). By 2007, property taxes accounted for 3.4 percent of total personal income, or roughly \$1750 per household using an unweighted average for all states. Visible, lumpy taxes induce economizing preferences in local taxpayers, just as budgetary changes in Denmark in the 1980s and 1990s did (Schwartz, 2001, 131-155). And as rising housing prices feed into higher property taxes through rising assessments, it becomes harder to increase other taxes for national purposes.

Homeowners’ hostility to inflation reverses the pattern prevailing in the 1960s and 1970s. Then, housing market incumbents benefited tremendously from inflation,

which rapidly and effectively reduced the real burden of their fixed mortgages while inflating the nominal value of their home. Home buyers in the 1960s and 1970s typically used *fixed rate*, long amortization mortgages and did not have HELOCs. And they typically had reasonably secure jobs with the expectation of some seniority based increases in their wage. Given these conditions, a fixed rate mortgage in an inflationary environment was a one way bet in favor of debtors, particularly since people moved less frequently. These conditions are gone. The massive shift from bank held fixed loans to securitized, floating rate loans has transferred inflation risk away from banks and the financial system and on to the buyers of houses and to a lesser extent the buyers of MBS backed by those houses.

One final group encompassing households from all three groups needs to be examined closely to understand the political consequences of the housing market boom. One-third of white households with children have an annual income in excess of \$100,000. This group only constitutes about one fifth of the voting population, but put simply, if you don't win this group, you don't win elections. This group encompasses the people who actually run organizations, form public opinion, and provide the decisive votes arbitrating between parties representing different groups of businesses.

The top decile by income, which encompasses much of this core third of white families, also encompasses two different groups. The top one percent of the population, or top ten percent of this decile, controls roughly 20 percent of wealth (and a bigger share of corporate equities). They are the bourgeoisie, to the extent that this label is useful. The rest of this decile, the other 9 percent, receives the bulk of their income – 5/6s – from wages (Dumenil and Levy 2004, 107). Their capital income is helpful, particularly in

retirement, but does not convey control over capital. But the top 1 percent cannot control either the economy or the polity without the consent of the rest of the top decile.

This group is sensitive to the value of their housing because they not only have primary residences but often have a secondary residence as well, effectively doubling their bet on housing assets. The median dual home owner had a 2004 income of \$123,000 and total home equity of \$376,000, representing 34 percent of their non-pension wealth (Federal Reserve Bank 2004; Engelhardt 2005, 54). While this later group is not coterminous with the whole upper third of white families, it gives a good sense of this better off fraction. For the average household in the top decile of the income distribution housing equity amounts to about one-fourth of total wealth. Thus this group is also sensitive to changes in nominal interest rates that might devalue the equity in their houses, even though their financial holdings are substantially larger than their non-financial assets.

Finally, it is important to note the substantial difference between the classic processes of wealth and job creation in the era of the ‘Keynesian welfare state’ and the current era. Central banks used high liquidity in both eras to boost employment and growth. What differs is the pathway by which increased aggregate demand is formed. In the Bretton Woods, lower interest rates mostly ramified through the economy via increased investment in the manufacturing sector that in turn led to higher levels of employment and wages. The broad increase in wages then validated *ex post* the original increase in investment. Growth rested on broad and equitable increases in income.

During the 1990s boom, increased consumption flowed not from increased investment percolating through economy wide wage increases. Instead, falling interest

rates boosted the value of marketable assets, including the newly marketable value of domestic housing. Financial deregulation enabled households to capture and sell that increase in asset and especially housing values and thus expand consumption. Because housing equity is highly unequally distributed, growth magnifies existing inequities by endowing housing market insiders with huge amounts of potential consumption and/or wealth. Meanwhile those without a foot in the housing market at the time prices began rising are shut off from wealth formation. As the other papers note, this implies widening intergenerational inequities.

The current crisis meanwhile pits the financial sector against households. Households lose from short run inflation. But the FED is abetting the financial sector's desire for an inflationary bailout of their positions in subprime MBS. A little inflation helps sustain the nominal price of the housing that collateralizes those mortgages and thus averts a financial system meltdown. It remains to be seen if this solution is politically and economically stable over the long run.

Conclusion

As Randall Germain argued, all levels of finance are ultimately connected (Germain, 1997). At the lowest level markets are highly competitive and exchange is often anonymous. At the highest levels finance is profoundly political and reflects interventions by central banks and their states. In the middle are national and industrial markets controlled by enterprises of various sizes. But all three markets usually interconnect and the political content of the highest levels inevitably filters down to the lowest levels. The current conjuncture is no different. Asian and oil exporters' central

banks abetted US financial arbitrage by recycling of US current account deficits. At the local level in the US and other countries, this arbitrage ramified through the housing market system through sales of mortgage backed securities organized by specialist mortgage brokers, national securitizers of those MBSs, and investment banks.

The housing price boom low interest rates and low inflation engendered created compelling reasons for various groups to prefer a continuation of that general environment even as the bust began. Homeowners' consciousness and thus political preferences have changed as housing became a tradable asset. The idea that housing (and equities) is the 'only game in town' for wealth accumulation and thence for income security in old age is widespread (*vide* Watson's contribution). And indeed, for anyone unwilling to depend on the near poverty line income provided by the US old age pension (the maximum annual payout is currently \$24,000), this is certainly true. People's rational (logic of consequences) orientation towards homeownership, low inflation and low taxes thus inevitably shifts into a more value-rational (logic of appropriateness) attachment to those things.

The decade plus connection between US global financial arbitrage and domestic housing driven Keynesian also caused similar changes to policy, identity, and preferences other countries. The connection between rising housing prices and differential growth did not pass unnoticed. Consequently financial regulators in many European countries tried to create regulatory structures that can accommodate a more active and liquid market for mortgage backed securities, usually based on the Danish system of mortgage backed bonds. Currently, securitized mortgage debt represents less than 10 percent of

GDP for most European countries, and less than 20 percent of all mortgage debt for the whole EU (European Mortgage Foundation, 1994, 116; 2007, 34).

However, securitization requires standardization, because securities bundle together loans that behave similarly and thus predictably. Securitization rests on common valuation standards, loan contingencies, maturities, pre-payment provisions, etc., as well as overcoming differences between Roman and Common Law treatments of assets. Securitization also requires a shift away from short term loans towards longer loans, since it is pension and insurance funds that are the major domestic buyers of MBSs. Securitization thus will further homogenize national markets in Europe and the European market as a whole, because MBS are subject not only to national but also to EU regulation because of their implications for the stability of national financial systems. The EU enabled securitization in a 1988 directive, but the take up has been slow. By opening the door to securitization and American style housing market Keynesianism, these changes in regulation might create the same constituencies that are politically resistant to inflation and taxes in the US subsequent to its round of housing market Keynesianism.

In the US, the disinflation of the 1990s combined with the operation of global capital markets to produce increased aggregate demand because of the US' combination of high levels of mortgage debt relative to GDP and easy refinance of those mortgages. In turn, this increased aggregate demand produced a self-fulfilling increase in employment and output that benefited both subaltern groups and politically critical cohorts. These groups in turn now have strong interests in cash income over collective social services and in keeping inflation, and thus nominal interest rates, low. The

interests and consciousness of current housing markets is thus a force for the maintenance of conservative economic policies and politics. Hegemony thus has very local roots, even though those roots are watered by cash flowing down from global financial markets.

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NOTES:

¹ See Schwartz (2009) for an analysis. Brad Setser (2006) argues that exactly the opposite is true, that the US lends short term to the world and then borrows back long term. But this is not plausible given the rate of return data. His case rests on high levels of US short term lending to international financial centers in London and the Caribbean. But surely these financial centers are dominated by US banks which then re-lend long term.

² A mortgage backed security (MBS) bundles discrete mortgages into one or more bonds that can be sold in the open market.

³ Privatization spun out the unsubsidized portions of FMNA as FMNA, leaving behind “Ginnie Mae,” the Government National Mortgage Agency, to provide subsidized lending for public housing projects.

⁴ The reverse might also be true: inflation may percolate through housing markets in differentially detrimental ways. Our point here is not that at all places and at all times

US-style housing market institutions produce superior employment outcomes. Our analysis only shows that this was true during the 1990s. Lane Kenworthy's (2002) findings are relevant to this point, because he finds that the relative job creation ability of coordinated and liberal market economies inverted around 1990/92. This suggests that *rising* nominal interest rates adversely affected countries with US style housing markets in the first period.

Table 1: *Relative Share of FDI, Portfolio Equities, Portfolio Debt, Loans and Derivatives in International Holdings, year end 2006*

<i>\$ Billion</i>	FDI*	Portfolio Equities	Portfolio Debt**	Loans	Derivatives	Total
US to world	2,855	4,252	1,181	3,938	1,238	13,754
World to US	2,099	2,539	5,408	4,356	1,179	15,930
<i>% shares</i>	FDI*	Portfolio Equities	Portfolio Debt**	Loans	Derivatives	Total
US to world	20.8%	30.9%	8.6%	28.6%	9.0%	100.0%
World to US	13.2%	15.9%	33.9%	27.3%	7.4%	100.0%

Source: BEA website, *International Investment Position*. * Current Cost Valuation; ** omits holdings of currency and official US government holdings totaling \$292 billion