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Paulson's Wild Ride on the Hindenburg: "The worst has just begun"

By Mike Whitney

15/02/08 "**ICH**" -- -- It's a good thing Hank Paulson wasn't around in 1929 or we'd all be hawking apples on a street-corner. Paulson is currently on a losing-streak that would have been the envy of Marvelous Marv" Thorneberry and the '67 Mets. In the last three months he's put together three new programs to deal with the subprime crisis which have fizzled out in a matter of weeks. First, he tried to entice struggling investment banks to put their mortgage-backed bonds in a Super SIV (structured investment vehicle) to see if it would help off-load billions of dollars of down-graded junk onto unsuspecting investors.

That flopped. Then he brokered "Hope Now" (1-888-995-HOPE) which was designed to help the banks and homeowners work out the details for a rate freeze on mortgage resets. Paulson assured the public that 500,000 homeowners would take advantage of the program, which would dramatically reduce rate of foreclosures. So far, the Hope Now hotline has provided counseling to just 36,000 borrowers. Representatives have suggested loan workouts for fewer than 10,000 of them, a small fraction of borrowers in need." (Earlier Subprime Rescue Falts; Wall Street Journal) "Only 10,000 homeowners; and Paulson promised 500,000? Another slight miscalculation.

This week, Paulson announced another new program, "Project Lifeline", which targets homeowners who are delinquent 90 days or more on their mortgages. Here's a run-down of how it works: (thanks to Calculated risk)

"Project Lifeline involves servicers sending letters to borrowers--prime, Alt-A, or subprime, we're past pretense on that part--who are very seriously delinquent (90 days or three payments down or more). The letter says that if the borrower contacts the servicer within ten days, agrees to homeowner counseling, and provides

sufficient financial documentation that the servicer can consider a case-by-case, deep-analysis style modification of the mortgage terms, the servicer will agree to put the foreclosure process on hold for 30 days while the workout is considered. If the borrower fails to respond to the letter, foreclosure proceeds.""

At the very best, the program just buys a little more time for the homeowner to pick out a nice rental where he and his family can live after the bank repossesses his home.

So far, all of Paulson's solutions have been nothing more than business-friendly band-aids which fail to address the core issues of rising foreclosures, falling home prices, skyrocketing inventory, and tumbling sales. Yesterday, at a press conference in Washington, Paulson made this shocking admission in response to a reporter's question:

Reporter: "Sir, is the worst over, yet? Will 2008 have fewer foreclosures?"

Secretary of the Treasury Paulson: "In terms of sub-prime and the resets, the worst isn't over. The worst is just beginning.... There's close to 2 million adjustable rate mortgages where the rate is going to be reset over the next couple of years. These loans are of a vintage where there was the most lax underwriting. So, this is the biggest challenge and this is why this is so important." (see the video at [Calculated Risk](#))

Paulson is right; it is important. So, why is he wasting time with these bogus public relations gambits when he should be making serious recommendations?

Paulson's so called "mortgage modifications" just don't cut it. They're pointless. They just put off foreclosure until a later date. The only real solution to the problem is renegotiating the mortgages with the lenders so that people with negative equity have an incentive to continue making their monthly payments. Otherwise, the number of "walkaways" will mushroom and wreak havoc on the entire industry.

This week's housing stats from California illustrate how desperate the situation really is. DataQuick Information Systems said Wednesday a total of 9,983 homes were sold in Los Angeles, Orange, San Diego, Riverside, San Bernardino and Ventura counties last month, a drop of nearly 50% from January last year.

50%. That is unprecedented. California is in a housing depression. Is a 30-day grace period really the best that Paulson can come up with?

That's nuts. California is a vital part of the US economy. In fact, California and Florida combined represent two-fifths of the nation's GDP. Is Paulson planning to

let California go the way of New Orleans?

For the last four months, housing sales in California have plummeted 40% (year over year) At the same time, prices in Southern California have dipped a whopping 16.7%. The market is freefalling. So far, the only analyst to come up with a reasonable solution is Professor Nouriel Roubini who suggests a three year rate-freeze and a reduction of the face value of the mortgages by the banks.

Of course the banks will scream bloody murder, but it's the only way to stem the tide of foreclosures and prevent a crisis that could suck the rest of the economy down a black hole.

And, for those who still doubt that a collapse in housing will batter the broader economy; here's a video of Yale economist Robert Schiller that drives the point home. Schiller predicted the dotcom bust in 2000 and is widely respected for his analysis of the real estate bubble. <http://econvideo.blogspot.com/>

"A HISTORIC HOUSING BUST"

Economist Robert Schiller: “

"We are in a historic housing bust comparable to that of the Great Depression. Prior to the Depression housing prices only rose 19% (between 1921 to 1925) and then fell 30% The cycle we are going through now, is a unique cycle; it will go down as the subprime cycle. The excitement in housing was unprecedented and the unraveling of that (bubble) will have unpredictable consequences.... Real estate owned by households is roughly \$20 trillion and we've already seen an 8% decline which means a loss of \$2 trillion. That has a powerful impact on the economy...The losses are throwing peoples' balance sheets off. So now household balance sheets are in bad shape. People who used to be able to borrow against their house are facing new constraints. This is an ongoing thing that will last for more than a year. So we have unfolding problems to forward to."

"We should be thankful that we have Ben Bernanke, who is an expert about the Great Depression at the helm. I don't think he will make the same mistakes that the Fed made that last time around... On the other hand, it (the bubble) is a major misalignment and cutting rates---when homes prices have doubled in the last decade---won't

change that. The correction (in home prices) is not going to be stopped by the Fed."

"If this isn't handled right, this could be a serious recession.""

Notice how Schiller dismisses inflation as a major concern and emphasizes the potential dangers of a deflationary downturn. It's clear that he would prefer to see Bush increase the \$168 billion than face an economy that is stuck in neutral. In other words, he anticipates a collapse in consumer spending.

Schiller continues:

"I am a big believer that 'confidence matters'. What is happening now, is that people are getting a succession of scare stories and personal savings are down... If you look at what happened before the Great Depression.....there was evidence of a sudden and sharp drop in consumer confidence and people pulled back and stopped spending. And we are seeing consumer confidence falling and I expect that it could take a much bigger tumble if we don't do something.""

Are you listening, Hank Paulson?

Consumer spending is down (excluding food and fuel) and consumer confidence is falling at the fastest pace since the 1990-91 recession. Also, \$2 trillion has been wiped out from falling home prices and another \$600 billion will vanish this year from mortgage equity withdrawals (MEWs). Traffic to the shopping malls has slowed to a crawl and retail shops had their worst January on record. Homeowners are hoarding their earnings to cover basic expenses and to make up for their lack of personal savings. The spending-spigot has been turned off. America's consumer culture is in full-retreat.

Everything Schiller said is taking place right now. So, where's the political leadership? Does anyone in Washington even have a game-plan?

In the fourth quarter of 2007, new foreclosures averaged 2,939 a day, double the pace of a year earlier. Business inventories are on the rise. This week's release of the Institute for Supply Management's Non-Manufacturing Index (ISM) showed steep declines in all areas of the nation's service sector---including banks, travel companies, contractors, retail stores etc—The Business Activity Index, the New

Orders Index, the Employment Index, and the Supplier Delivery Index have all contracted at a historic pace.

These are the classic signs of overproduction. The next shoe to drop will be rising unemployment. Layoff notices have already gone out in new construction, retail, car manufacturing and financial services. This is all the predictable outcome of low interest” bubble-making. It invariably ends in a painful deflationary spiral.

“Confidence matters,” Schiller warns.

Yes, it does. But the American people lost confidence in their leaders long ago. So--like Paulson says--the worst is probably just beginning.

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