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# Is This The Worst Ever Yet?

Peter D. Linneman
*University of Pennsylvania*

## Is This The Worst Ever Yet?

### Abstract
In this publication's last issue, John Williams and the author determined that the 2008 recession was the "least worst" of the recessions of the past forty years. Now, the author says, we are in the second-worst recessionary period of the last forty years, and it is worsening fast. But do not bet against the U.S. economy, he cautions. Entrepreneurs are still out there, and with a modicum of political leadership and stable economic policy, we will get through this stronger than ever. Realistically, we cannot save everyone, but in the Chapter 11 limbo, companies can try to reconstitute themselves; "special" bailouts do nothing but redistribute income according to political clout. Losers must lose if winners are to prosper. If one or more of the "Hopeless Three" (U.S. auto manufacturers) goes bankrupt, their competitors' sales will rise; their operating margins will improve, allowing them to avoid financial distress and expand output and employment domestically. As with wildebeest in the Masai Mara, death is essential to life. People knew that leverage could be risky. Debt is wonderful on the upside, but remorseless on the downside. This lesson will hopefully be remembered for a new generation.

### Disciplines
Real Estate

# Is This the Worst Ever Yet?

*A comparison of historical recessions.*

**PETER LINNEMAN**

**IN THE LAST ISSUE** of the *Wharton Real Estate Review*, John Williams and I examined how the 2008 recession compared to the six recessions of the past forty years. We noted that—as of that time—the current recession was the "least worst" of the seven episodes. An updated analysis indicates that we are in the midst of the second-worst recessionary period of the last forty years, and it is worsening fast (Tables I and II). But do not bet against the U.S. economy. Entrepreneurs are still out there, and with a modicum of political leadership and stable economic policy, we will get through this stronger than ever. However, it will take

**Table I:** "Worst ever" U.S. recessions over the past 40 years

| | 12/69-11/70 | 11/73-03/75 | 01/80 03/80 | 07/81-11/82 | 07/90 03/91 | 03/01-11/01 | 12/07 01/09 |
|---|---|---|---|---|---|---|---|
| Duration in Months | 12 | 17 | 3 | 17 | 9 | 9 | 14 |
| Change in GDP (%) | -0.4% | -3.5% | -0.7% | -2.7% | -1.4% | -0.2% | 0.4% |
| Change in Payroll Employment (%) | -1.2% | -1.6% | 0.2% | -3.1% | -1.1% | -1.2% | -1.9% |
| Change in Real Household Net Worth (%) | 1.7% | -10.1% | -1.8% | -1.4% | -3.5% | -3.4% | -4.3% |
| Change in Auto Sales (%) | -29.2% | -30.4% | -15.9% | -12.5% | -15.2% | -6.2% | -36.0% |
| Change in Industrial Output (%) | -7.1% | -15.0% | -0.8% | -8.5% | -4.4% | -4.0% | -9.9% |
| Change in Real Sales by Retail Stores (%) | -2.1% | -9.5% | -4.9% | -5.1% | -5.2% | -1.3% | -13.2% |
| Change in Construction Contracts for C&I Builidings (%) | -37.6% | -52.2% | -21.1% | -41.3% | -25.0% | -33.6% | -28.6% |
| Percent Real Return in S&P 500 | -23.2% | -39.9% | -12.9% | -23.2% | -16.5% | -11.3% | -50.4% |
| Change in Real Median Home Price (%) | -15.8% | -4.0% | -3.1% | -8.7% | -6.2% | -1.1% | -7.4% |
| Change in Real After Tax Profit (%) | -13.3% | -30.4% | -12.7% | -6.8% | -12.3% | -8.3% | -4.3% |
| Lowest Consumer Confidence Level (Monthly) | 72.4 | 57.6 | 62.1 | 65.7 | 65.1 | 88.6 | 57.0 |
| Change in Housing Starts | -17.5% | -30.5% | -32.7% | -25.1% | -31.6% | 2.1% | -43.4% |
| Highest Inflation Rate (Monthly) | 6.4% | 12.2% | 14.6% | 11.0% | 6.4% | 3.6% | 5.5% |
| Highest Unemployment Rate (Monthly) | 5.8% | 8.3% | 6.3% | 10.7% | 6.8% | 4.8% | 7.2% |

**Table II:** Ranking of U.S. recessions over the past 40 years

| | 12/69-11/70 | 11/73-03/75 | 01/80 03/80 | 07/81-11/82 | 07/90 03/91 | 03/01-11/01 | 12/07 12/08* |
|---|---|---|---|---|---|---|---|
| | | | (Rank Order (7 is Worst; 1 is Best) | | | | |
| Duration in Months | 4 | 6.5 | 1 | 6.5 | 2.5 | 2.5 | 5 |
| Change in GDP (%) | 3 | 7 | 4 | 6 | 5 | 2 | 1 |
| Change in Payroll (%) | 3.5 | 5 | 1 | 7 | 2 | 3.5 | 6 |
| Change in Real Household Net Worth (%) | 1 | 7 | 3 | 2 | 5 | 4 | 6 |
| Change in Auto Sales (%) | 5 | 6 | 4 | 2 | 3 | 1 | 7 |
| Change in Industrial Output (%) | 4 | 7 | 1 | 5 | 3 | 2 | 6 |
| Change in Real Sales by Retail Stores (%) | 2 | 6 | 3 | 4 | 5 | 1 | 7 |
| Change in Construction Contracts for C&I Builidings (%) | 5 | 7 | 1 | 6 | 2 | 4 | 3 |
| Percent Real Return in S&P 500 | 4.5 | 6 | 2 | 4.5 | 3 | 1 | 7 |
| Change in Median Home Price (%) | 7 | 3 | 2 | 6 | 4 | 1 | 5 |
| Change in Real After Tax Profit (%) | 6 | 7 | 5 | 2 | 4 | 3 | 1 |
| Lowest Consumer Confidence Level (Monthly) | 2 | 6 | 5 | 3 | 4 | 1 | 7 |
| Change in Housing Starts | 2 | 4 | 6 | 3 | 5 | 1 | 7 |
| Highest Inflation Rate (Monthly) | 3.5 | 6 | 7 | 5 | 3.5 | 1 | 2 |
| Highest Unemployment Rate (Quarterly) | 2 | 6 | 3 | 7 | 4 | 1 | 5 |
| Total Rank Score | 54.5 | 89.5 | 48 | 69 | 55 | 29 | 75 |
| **Number of Worsts** | **1** | **6** | **1** | **3** | **0** | **0** | **5** |
| **Number of Bests** | **1** | **0** | **4** | **0** | **0** | **8** | **2** |

* 2008, Construction contracts, comparisons are through 2Q08.
2008 Median Home Price comparisons are through Oct. 2008.
2008 GDP, net wealth, A/T profit are through 3Q 2008.
2008 S&P Percent Real Return calculated at lowest reading on 11/20/08.
2008 payroll employment, auto sales, industrial output, and real retail sales are through Nov. 2008.

more time than we thought, due to the needless panic that has been created by our so-called political leadership.

The dotcom bubble gave rise to a belief that fabulous riches could be achieved by age thirty (thirty-five if you are dumb) through financial models, flip books and PowerPoint presentations. The goal became: fool "them" to give you big money; cash out a short time later; buy a sports franchise and never work again. "Only chumps work past thirty-five" became the prevalent culture. But great business enterprises, and the jobs and fortunes they create, are the result of decades of hard work and execution, not of fast, nifty financial models. Getting rich slowly is the American way, and most overnight successes prove to be fools' gold.

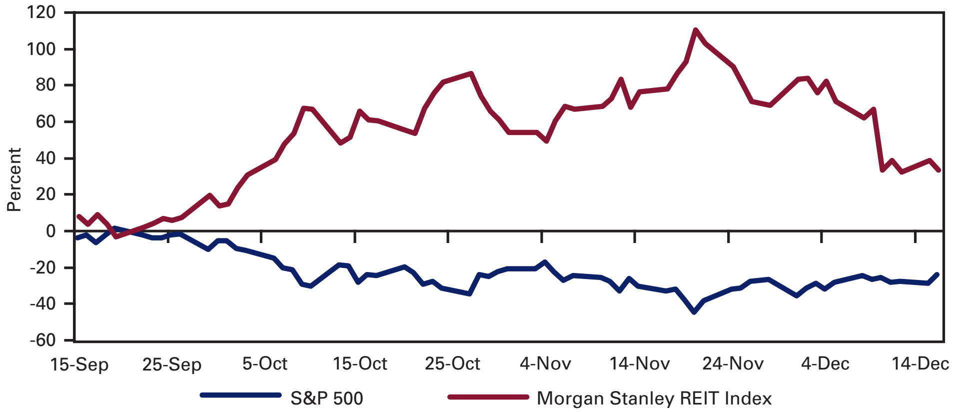
Many of us bear blame for creating the impression that flash presentations and models, rather than grinding it out, are the sure route to riches. Business schools reinforced the idea that clever ideas trump painstaking execution. And faculty made it acceptable for students to float by as long as they had good financial modeling skills. But there is no substitute for rolling up your sleeves every day and working hard on the details. This is true even if you are a genius. We have all done capitalism a great disservice by not saying that the "get rich quick" emperor has no clothes.

## WE CALLED IT—ALMOST

In December 2005, I wrote that failed political leadership, Fed policy errors, and private-sector hubris would cause a recession in 2009. Did I foresee the magnitude of the Great Capital Strike or the current recession back then? Of course not. But I knew that humans being human meant that hubris would have its day. The last time it was technology, while in the 1980s it was commercial real estate, as well as Fed policy errors fueling hubris in housing and finance. And talk about hubris: financial firms operating at 35:1 debt-to-equity ratios apparently believed that they were incapable of 3 percent errors (which would have wiped out all their equity).

The serial disaster of the Troubled Asset Relief Program (TARP) turned what might have been a typical recession into a very serious recession. After failing to save Lehman from bankruptcy but supporting AIG, and forcing several shotgun mergers, President George W. Bush, Fed chairman Ben Bernanke, Treasury Secretary Henry Paulson, presidential candidates McCain and Obama, as well as the leadership on both sides of the aisle in both chambers of Congress, triggered widespread panic when they announced on September 24 that the world would end if they did not enact legislation saving us. Overnight they managed to generate total panic on Main Street.

**Figure 1:** S&P 500 versus Morgan Stanley REIT Index, cumulative % change from Sept. 15, 2008



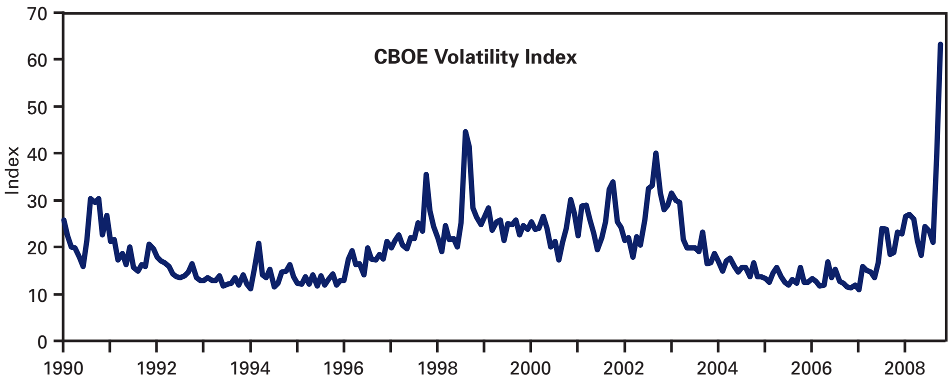

On the morning of September 29, this assembly of bipartisan leaders proudly announced that they had drafted legislation that would save mankind—only to watch as their handiwork was handily defeated. No true political leader should ever call for a critical vote without knowing that he or she actually has the votes. Yet the entire political leadership of both parties was clueless about the fate that awaited their proposed legislative salvation. The magnitude of this political failure was grasped by investors, who wrung their hands with a 9.7 percent sell-off between September 26 and September 29 S&P 500 close (Figure 1).

The farce did not end there. Four days later, Congress easily passed the same basic TARP proposal, supplemented with loads of pork, including appropriations for a NASCAR race track and tax breaks for a toy manufacturer of wooden arrowheads. This political travesty, combined with the abandonment of economic policy for ad hoc decision making, caused a run on banks and money market funds, and a surge of hedge and mutual fund redemptions.

Instead of clear and consistent policies, the Bush Administration took on a transparency and consistency worthy of Mugabe's Zimbabwe or Putin's Russia, and abandoned considered policy for ad hoc "deals." But when the rules of the economic game disappear, so too do the people willing to play that game. So it was not a surprise that when economic rules became idiosyncratic and unpredictable, people rushed to cash and government bonds. The "deal" approach of the past six months will go down as one of the darkest eras of U.S. economic policy, creating a far deeper recession than was necessary.

The disaster continued. On October 14, Secretary Paulson (after appointing an inexperienced thirty-five-year-old to head

**Figure 2:** Volatility is off the charts




Source: Chicago Board Options Exchange

TARP) announced that he would use $250 billion of the $700 billion to inject preferred equity in selected banks (no description was offered of how they would be selected)—after months of saying that this was not the right path. Then on November 12, he announced that he would not purchase any troubled assets, but would inject funds into banks and other companies (such as auto makers). This announcement was delivered with no apology and no apparent concern for the consequences of such a wildly changed "policy." Stocks fell another 5.2 percent and volatility grew as policy evaporated (Figure 2).

As governments around the world stepped in to prop up their banks, global stock markets plummeted, registering their opinion of the long-term impact of the global drift toward socialism and of ad hoc "pragmatic decision making" rather than a reliance on markets and consistent economic policy.

## BE WARY OF SAVIORS

In the past few months, we have discovered what it is like to live in a world where economic success and failure hinges primarily on government dictate rather than on markets satisfying customers and competition. As the U.S. Treasury made deals to "save" the economy, the economy reacted like a patient with a penicillin allergy who had been given penicillin. As the rules of the economic game were replaced by government fiat, people withdrew en masse from the economic game.

Uncertainty is the deadly enemy of efficient decision-making, and the government's daily attempts to "save us" ratcheted up the level of economic uncer-

**Figure 3:** Payout ratio vs. long-term shareholder returns

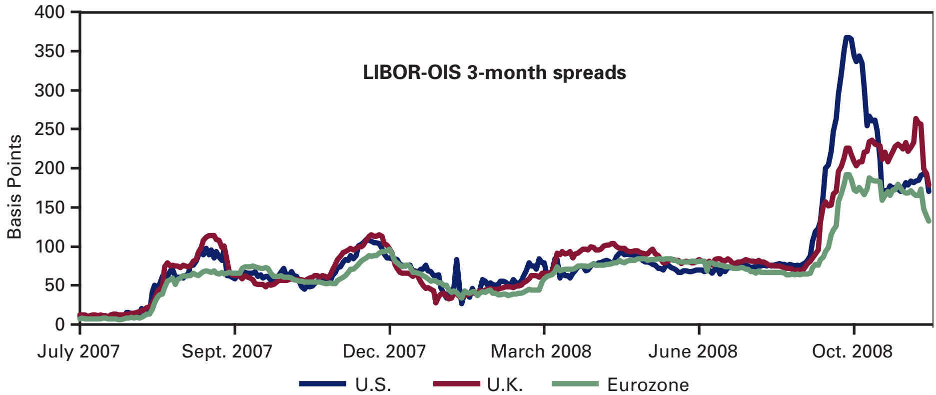
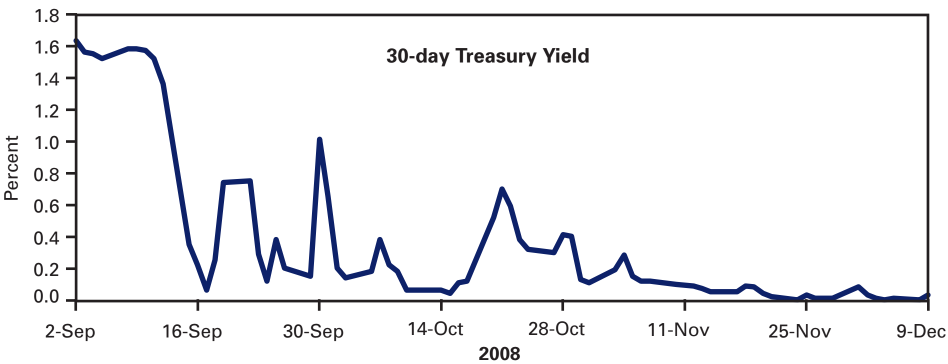



**Figure 4:** Real short-term yields are negative




tainty (Figure 3). As uncertainty skyrocketed, the economy collapsed. Faced with government-created panic, common citizens sought cash by runs on banks and mutual funds, while sophisticated investors sold everything they could to move into government notes. Short-term Treasury bill yields took a nosedive, resulting in negative real returns (Figure 4). Just as the economic fabric is thin in government-dictated economies such as Russia, Zimbabwe and Venezuela, so too the collapse of the rule of economic law has crippled the U.S. economy.

This abrogation of rules was underscored by the lame-duck Treasury's decision to bail out the Hopeless Three automakers at unspecified terms, within twenty-four hours after U.S. lawmakers defeated a bailout bill (which was opposed by 65 percent of Americans). This decision made a mockery of the legislative process,

**Figure 5:** Crude oil prices are closer to the historical average

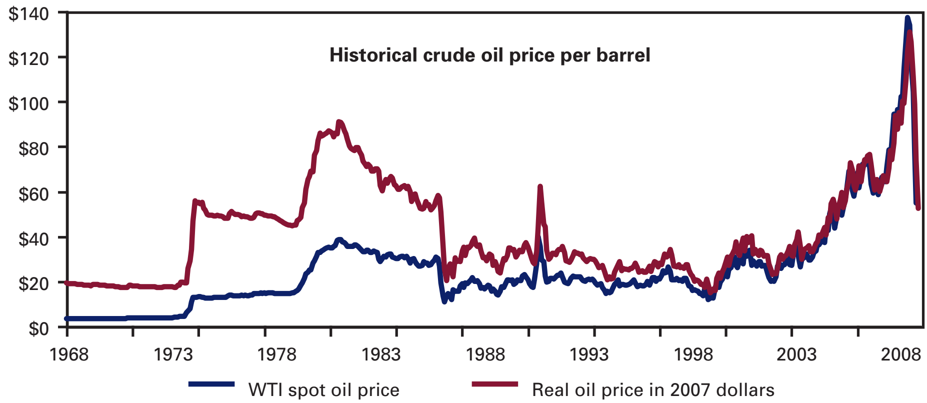
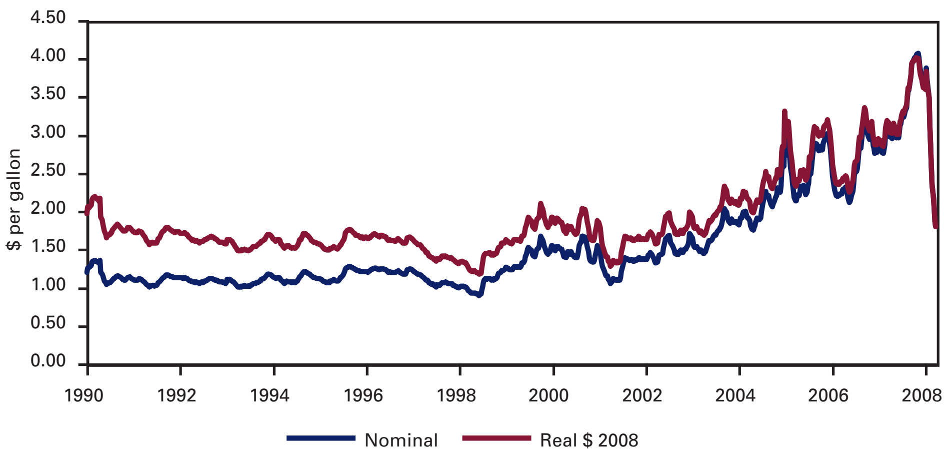



**Figure 6:** Retail gas prices have moderated




Source: U.S. Dept. of Energy

and was the nearest thing to a political coup that we have witnessed in the United States during our lifetime.

The economy will rebound from a needlessly deep recession far more quickly than most anticipate. This is particularly true in view of the enormous decline in the price of oil. Using the rule of thumb that each $10 increment in oil price above $30 per barrel reduces GDP by roughly 30 basis points, the recent oil price decline provides a 3 percent stimulus.

A major and widely overlooked cause of the worldwide recession was the precipitous run-up in oil prices to $147 per barrel (Figures 5 and 6). As rapidly elevated oil prices worked through economies around the world, the economic burden

**Figure 7:** U.S. auto sales are dismal

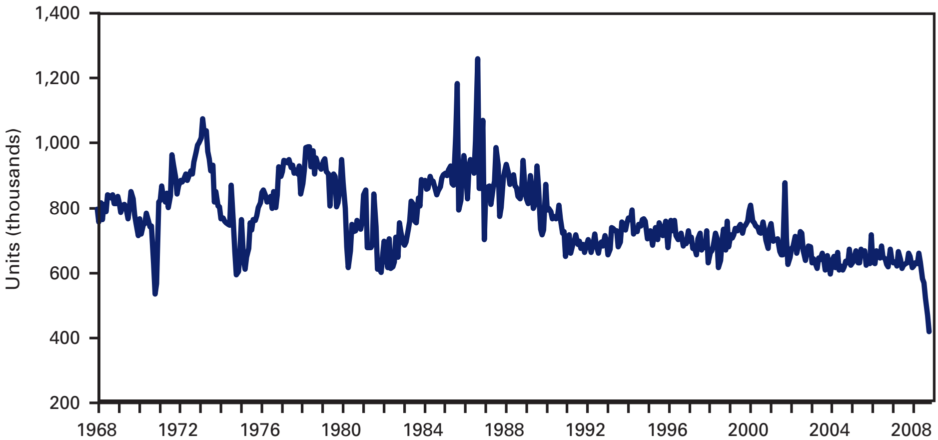
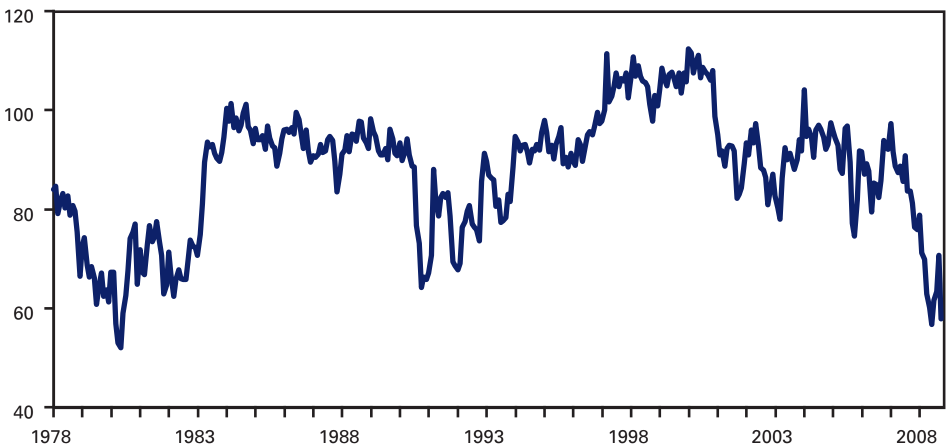



**Figure 8:** Consumer sentiment is the lowest in 40 years




Source: University of Michigan Consumer Sentiment; 1984=100

became unbearable and global growth plummeted from 4.5 percent to less than 2.5 percent.

U.S. auto sales declined roughly 30 percent from their peak in the third quarter of 2005, while consumer real expenditures on gasoline and related products fell by 6 percent over the same period (Figures 7 and 8). In fact, monthly auto sales declined by $18.1 billion when comparing June 2007 to November 2008. Total monthly retail sales declined by $18.6 billion during that time. As was the case during the Weimar Republic, when people sought "salvation" in dubious political leaders, these are dangerous times. The fact that $700 billion in "salvation financing" was hurriedly passed by Congress only to become a blank check public welfare program for the politically connected should underscore our concern.

There are reasons why governments around the world sold off much of their nationalized interests over the past two decades, including: scandals arising from political lending, hiring and contracting at nationalized firms; a lack of financial and managerial innovation; a financial system run with the plodding effectiveness of the U.S. Postal System; the lack of responsive customer service; ever-growing subsidies to support inefficient financial entities; large losses suffered on loan portfolios; politicians retiring to well-paid cushy bank directorships. It was a *state-owned* German bank that was so asleep at the wheel that it wired €300 million to Lehman minutes before Lehman declared bankruptcy. Also, recall the political corruption that characterized state-owned banks in Mexico and Italy. And let us not forget the horrid underwriting record of state-owned Chinese, French, and German banks.

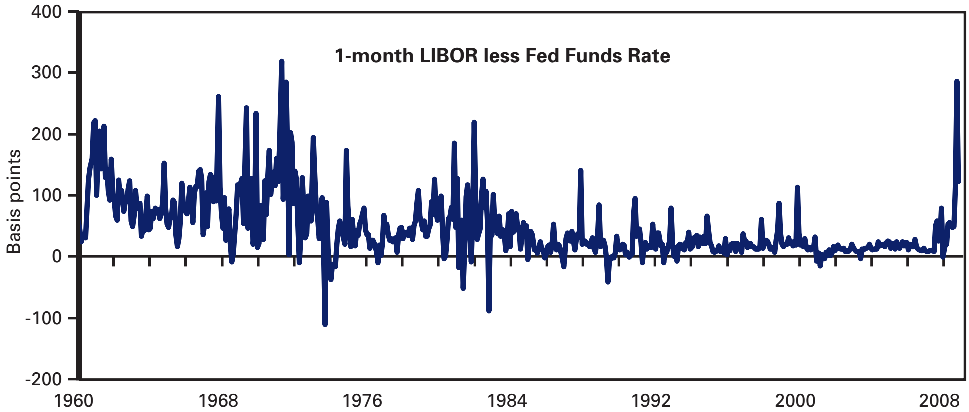
Why was Bear Stearns saved but not Lehman? Why were forced mergers arranged for some institutions but not others? Why was AIG saved? Why did TARP initially focus on a buy-in of assets rather than guarantees or equity infusions? Why was TARP $700 billion rather than $600 or $800 billion? Why was Citibank propped up while Indy Mac and Wachovia were set adrift? Why was the buy-in plan dropped in favor of cash injections just weeks later? Will short sales be allowed? And if so, for how long? Why was $125 billion in preferred equity earmarked for eight selected banks (as opposed to seven or nine)? Why $125 billion for all others? Why were the Hopeless Three provided access to TARP after Congress said no to subsidies? No one knows—or is willing to share—the answers to these questions.

The absence of a clearly articulated economic policy may be understandable, but it is not forgivable. This is an era in which reporters were embedded with our troops in Iraq, to assure that they "got the message out" expeditiously. The absence of a message in this case created widespread financial and economic panic, with cascading consequences.

## TRUST MATTERS

Without trust, any society will degenerate into petty survivalism. One of the primary functions of government is to codify basic trust (prohibitions against theft, rape, and murder) and to punish those (thieves, rapists, and murderers) who violate societal trust. Basic financial trust revolves around the belief that debts will be repaid,

**Figure 9:** Short-term spreads have sky-rocketed




that entities seeking debt and equity are truthful, and that governments will punish wrong-doers and not act capriciously. It is reflective of the serial failure of political leadership that from September 13 to November 21, not only did the stock market collapse and debt spreads substantially widen, but the commercial paper market all but ceased to function, and money market funds teetered. LIBOR spreads over the Fed Funds rate spiked 53 percent (from 248 basis points the day before the initial failed TARP vote to 380 basis points on October 10); REITs fell by 76 percent; while AAA CMBS spreads rose by 138 basis points, and the S&P 500 fell by 25.9 percent. Only the strongest and most transparent non-financial borrowers have been able to overcome this widespread lack of trust.

Like children playing the old game "button, button, who has the button?," capital sources have hoarded cash as they play "losses, losses, who has the losses?" Real yields on 30-day Treasuries reached -1.57 percent (Figure 9), underscoring the fact that many savvy investors were happier to experience guaranteed losses of merely 2 percent, rather than stumbling into huge losses, and as of December 19, the 30-year Treasury yield was 2.6 percent.

What the U.S. economy needs is the immediate and total disclosure of all assets and liabilities (with no materiality, safe harbor or off-balance sheet exceptions) from any institution with access to any form of state or federal guarantee. If you owe the donut delivery kid $10, just tell us and we'll decide whether it is a material liability. And mark-to-market valuations should be applied only to assets with active markets (for example, a bid-ask spread of less than 2 percent). A full disclosure requirement could be implemented immediately, and would allow investors to assess who holds the losses, restoring basic financial trust. It would also quickly reveal which financial institutions are insolvent, allowing public and private liquidity infusions to be given to only the living, while an RTC-like agency set about the orderly liquidation of the dead.

The losses of 2004 to 2007 have created a mine field. But just as there are a finite number of mines in a mine field, there are a finite number of losses. The real question is, who holds the losses? The strange thing is that each time a loss-mine explodes (Bear Stearns, Fannie/Freddie, AIG, Lehman, Wachovia, Washington Mutual), we become a bit safer, as there is one less mine to be inadvertently stepped on (this is true in spite of collateral damage to those near the detonation). Yet psychologically speaking, seeing firms blown to bits erodes our confidence, makes us feel more endangered, stops us dead in our tracks, and creates public panic.

What is required to get the economy out of this minefield of losses? Leadership! A great officer with troops stuck in a mine field: does not panic; keeps the troops from panicking; identifies the location of the mines; and expeditiously clears a path so that the troops may proceed forward. Only after the troops are safely out of the mine field does the officer worry about how much is paid to the victims and who is at fault for the troops marching into the minefield. There will be finger-pointing, but first the mines must be cleared away.

The mines the economy faces are the future losses associated with poorly underwritten investments made during 2004 through early 2007. The trouble is that we do not know how big these losses are, when they will occur, which firms hold these assets, or if these losses will wipe out their equity. Unfortunately, like a young lieutenant fresh out of West Point, our political leadership panicked in the mine field. This panic quickly spilled over to the troops on both Wall Street and Main Street. And we still do not know who holds the losses. Until the location of the losses is revealed, the economy and capital will largely stand around in a worried state, rather than moving forward.

This is going to be a recession rivaling 1973-1975, and it is going to take time to work our way through it. Unfortunately, the politically created panic coincided with the Christmas retail season. People fell into a post-9/11 mentality, where even if they had money, they did not spend because it seemed like the wrong thing to do. The result was even more bad economic news.

## THE WAY FORWARD

A large stimulus package is in the offing, but the evidence on the efficacy of such packages is highly questionable at best. At a theoretical level, government borrowing and spending largely only encourages the private sector to save more to service future debt burdens, reducing spending today. Moreover, there may be substitution between public and private spending. For example, if the government decides to feed all school children as a part of the stimulus package, private expenditures on children's lunches will fall dramatically, yielding little net change in the economy. The argument for government spending as a stimulus is most compelling for infrastructure programs, where little private sector substitution occurs. However, if expenditures degenerate into massive pork allocation, there will be a social loss.

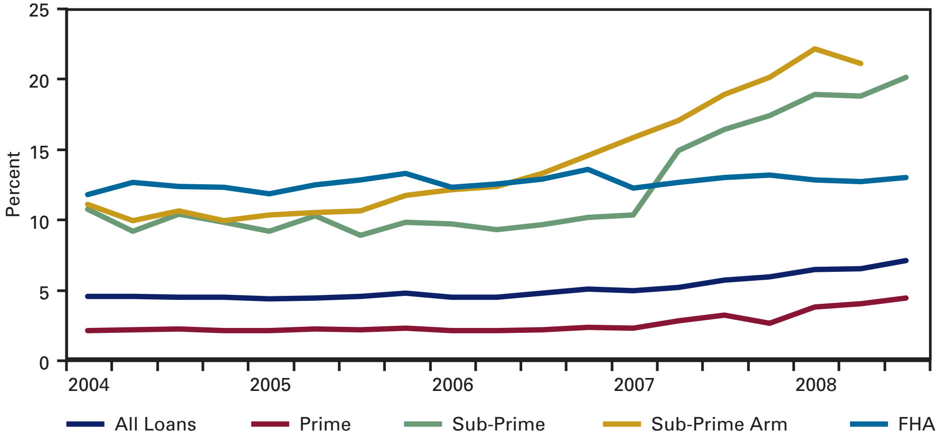
Contemporaneous descriptions of past recessions are always characterized by observations such as: "This is the worst I can remember;" "It has never been this bad;" "This one is different;" "This one will last much longer than previous ones;" "I don't see any catalyst to get us out of this one;" "There is no sector to lead us out of it;" and "This recession will fundamentally change the economy." Yet even as boardrooms, analyst reports, the media, and government officials make such statements, a sus-

**Table III:** Case-Shiller versus OFHEO home price indices through 3Q08

| MSA | Case-Shiller % change YE 2005 to 3Q08 | Case-Shiller % change 1-Year | Case-Shiller % change 3rd Qtr | OFHEO % change YE 2005 to 3Q08 | OFHEO % change 1-Year | OFHEO % change 3rd Qtr |
|---|---|---|---|---|---|---|
| Atlanta | (5.8) | (9.5) | (1.5) | 2.4 | (1.8) | (2.3) |
| Boston | (10.3) | (5.7) | (0.8) | (8.9) | (4.1) | (2.7) |
| Charlotte, N.C. | 7.9 | (3.5) | (2.3) | 15.9 | 1.6 | (1.7) |
| Chicago | (9.4) | (10.1) | (1.5) | 2.2 | (3.8) | (2.7) |
| Cleveland | (10.5) | (6.4) | 0.2 | (7.8) | (5.7) | (5.1) |
| Dallas | (0.2) | (2.7) | (0.4) | 8.7 | 2.6 | 0.0 |
| Denver | (4.8) | (5.4) | (0.5) | (1.9) | (1.0) | (2.2) |
| Detroit | (29.0) | (18.6) | (2.7) | (21.9) | (13.3) | (6.8) |
| Las Vegas | (36.1) | (31.3) | (7.5) | (26.4) | (26.8) | (12.6) |
| Los Angeles | (30.3) | (27.6) | (5.7) | (13.5) | (18.8) | (6.6) |
| Miami | (32.5) | (28.4) | (5.9) | (4.4) | (17.9) | (8.2) |
| Minneapolis | (17.5) | (14.4) | (0.7) | (7.3) | (6.5) | (4.3) |
| New York | (10.0) | (7.3) | (1.8) | 1.5 | (4.5) | (3.2) |
| Phoenix | (36.7) | (31.9) | (8.7) | (11.9) | (16.6) | (7.5) |
| Portland, Oregon | 3.5 | (8.6) | (3.1) | 13.9 | (2.6) | (2.3) |
| San Diego | (34.0) | (26.3) | (6.4) | (23.3) | (17.6) | (6.1) |
| San Francisco | (32.3) | (29.5) | (8.9) | (6.8) | (8.0) | (2.6) |
| Seattle | 5.3 | (9.8) | (3.1) | 16.3 | (3.0) | (2.2) |
| Tampa | (24.5) | (18.5) | (2.2) | (10.5) | (15.1) | (4.6) |
| Washington | (23.2) | (17.2) | (3.9) | (9.5) | (12.5) | (4.7) |
| | | | | | | |
| **United States** | **(19.8)** | **(16.6)** | **(3.5)** | **1.5** | **(4.0)** | **(2.7)** |

Source: Case-Shiller, Office of Federal Housing Enterprise Oversight, Linneman Associates.

**Figure 10:** Mortgage delinquency rates are on the rise




tained recovery is generally only months away. This time will be the same.

No modern recovery has had a "catalyst" to turn things around. In each case, sustained productivity growth, population growth, and a return to fundamentals were the routes to resumed economic growth. And the growth was not driven by an industry or sector, but rather by a broad-based recovery, with isolated lagging sectors. And rebounds, like downturns, happened far more rapidly than anyone predicted. This time will be the same.

Commercial mortgage-backed security (CMBS) must return to its simple roots: loan-to-value ratios of 50 percent to 60 percent; simple pass-through structures; high debt coverage ratios; pools of assets with similar risk characteristics (only apartments, for example); and over-collateralization. This simplified structuring would restore transparency, and when fear is rampant, transparency and simplicity maximize value.

The best news for real estate is that new construction financings were virtually non-existent in late 2007 and 2008. This will continue into 2009, meaning that weakening demand fundamentals will meet limited supply expansion, rather than the exploding supply that usually appears at the end of an economic cycle. Housing prices are down year-over-year by 4 percent for the nation, based on the OFHEO housing price index (Table III). By mid-2009, the housing markets will start to shift from an excess supply to the very early stages of an excess demand.

The roughly $1 billion in global losses by financial institutions are primarily associated with loans that are fully current. This means the losses are primarily conjectural losses associated with current loans (Figure 10). Are these staggering paper losses reflective of future cash flow losses, a greater liquidity premium, an increased risk premium, or sheer irrational panic? Probably all of the above, but no one knows for sure, as the actual losses will not be known for many years. Each time someone makes a payment on their mortgage, car loan, student loan, or credit card, the maximum potential loss declines. Only when every outstanding loan originated in 2004-2007 is either retired or settled via a post-foreclosure sale will the actual losses be tallied. This may take anywhere from three to twenty-five years. Until then, estimates of losses are a pure guessing game.

A poorly underwritten mortgage issued in February 2005 to a greedy speculative home flipper, at the behest of a snake-oil salesman peddling a "can't lose" proposition, with the assistance of a slimy subprime broker, cannot be magically transformed into a prudent loan. If instead of disclosing the loss-mines and getting the economy moving forward, we point fingers, pass counter-productive legislation, and raise taxes, our languishing economy will create unnecessarily large future losses.

We all need to admit "I am guilty" because: I did not argue forcefully enough that the excesses were crazy; I took some of that poorly underwritten debt; I invested in money market funds that bought anything rated AAA, irrespective of real asset quality; I financed (or built) a home or condo using excessively cheap debt; I invested in the stocks of firms that carelessly used cheap short-term debt to invest in highly leveraged illiquid long-term assets; I elected politicians who required Freddie/Fannie to take ever greater risks; I put my money in insured depositories without caring if they were making sound loans with my deposits. In short, this mess is my fault. Having accepted guilt, we can focus on identifying the location of the loss-mines and providing capital transfusions (both public and private) to the living, thus getting the U.S. economy back on track without creating unnecessary damage.

Even if the present value of the losses is ultimately $1.2 trillion, the full reimbursement of these losses via the proceeds of long-term federal debt will cost us less than $1.4 trillion (including financing costs), versus aggregate U.S. GDP of roughly $150 trillion to $170 trillion, and federal spending of $30 trillion to $35 trillion, over the next ten years. That is, for a mere 0.7 percent of our income over the next ten years, we can reimburse the maximum conceivable losses. It is only a few hours of work a year by each of us, and less than a couple percent of our net worth (spread over ten years).

So please take the "I am guilty" pledge, and urge our political leaders to cover the losses as they occur out of our future income. This is most easily be done by a ten-year federal guarantee of all remaining interest and principal payments due on every loan written from mid-2004 through mid-2007. After all, we are all guilty, so we should all pay.

This loan guarantee program (subject to a good faith requirement effort to collect on loans and a fraud exception) will spread the government cash flow burden over time, as payments will occur only as the loans default. This policy can be implemented with minimal effort and will instantly raise the value of loans by converting most qualifying debt to government debt valuation, thus allowing this debt to be sold efficiently as government credit, creating cash proceeds for new loans.

Everyone agrees that the financial system was substantially over-leveraged and that we need to de-lever. But no one with debt wants to be impacted by this policy. De-lever "them," not "me." But all deleveraging efforts must be concentrated on the debt that requires rebalancing, maturing loans, or new loans, as the lender cannot generally reduce lending on long-term debt. Hence, the de-leveraging of the system is 100 percent focused on about 20 percent of all loans. As a result, many wildly over-levered situations get a free pass, while new loans are stonewalled by lenders.

But if lenders make new loans, they will not achieve their leverage targets. It is like going from a diet of 3,000 calories a day to 900 calories a day: on such a diet, even a lot of healthy food has to be forsaken. However, once we hit our target weight, we can go to a 2,400-calorie diet. This will occur once lenders reach their target exposures.

The "de-lever them, not me" sentiment is the schizophrenic element of the lender bailout efforts. On the one hand, infusions of government money are intended to increase the asset base to more effectively match current leverage. At the same time, banks are being told to expand their lending. But the first task is to right-size lender balance sheets. Lending will resume once this objective is achieved.

## A FINAL THOUGHT

We must resist the urge to save everyone—Wall Street, Detroit, homebuilders, mortgage borrowers. Everyone has a "special" case to make. We have Chapter 11 as a limbo where companies can attempt to reconstitute themselves. This protection should be extended in a simple form to consumers. But "special" bailouts do nothing but redistribute income according to political clout, undermining confidence in economic outcomes, causing economic activity to drop precipitously.

Losers must lose if winners are to prosper. If one or more of the Hopeless Three goes bankrupt, their competitors' sales will rise as consumers shift their purchases. The increased sales realized by the competitors, who make their vehicles in the U.S., will improve their operating margins, allowing them to avoid financial distress and expand output and employment. As with wildebeest in the Masai Mara, death is essential to life.

Finally, people knew that leverage was not without risk. They relished its upside, and they now must suffer its downside. The idea that a reasonably safe real estate cash stream bought at a 4 percent to 5 percent cap rate could generate a 20 percent return is absurd unless premised on carry trades and loads of ever-available debt. But just as tenants do not always renew their leases, lenders do not always roll their loans. Debt is wonderful on the upside, but remorseless on the downside. This lesson will hopefully be remembered for a new generation.