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AHEAD OF THE TAPE

Housing Cycle Is Caught in Vicious Circle

By SCOTT PATTERSON
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Economists have a term to describe what it means when things keep going from bad to worse: negative-feedback loop. One day's problems create a broad set of behaviors that only make the problems worse.

Consider housing. As home prices fall, more families see the values of their homes decline to less than the amount of money they have to pay back on their mortgages. That gives them an incentive to walk away from their mortgages and leave their homes empty, which puts more downward pressure on home prices, drawing more households into the loop.

Housing turmoil, in turn, causes consumers to pull back, hurting the broader economy, which puts more downward pressure on home prices. Banks, worried about mortgages going bad, tighten lending standards, shutting some new buyers out of the market and further depressing home prices.

Negative-feedback loops can be pernicious when an economy depends heavily on borrowed money. Total outstanding household debt rose to $13.6 trillion by the third quarter of 2007 from $7.2 trillion at the beginning of 2001 -- a 10% annual growth rate. Mortgage borrowing more than doubled in this stretch. One out of every seven dollars of disposable income earned by Americans now goes toward paying down debt -- near a record.

Corporate borrowing was modest for most of the decade, then started rising at double-digit rates in 2006 and 2007, amid a wave of private-equity buyouts and debt-financed share buybacks. Meantime, Wall Street juices returns by making investments with borrowed money.

Yale economist John Geanakoplos's concept of the leverage cycle shows how negative-feedback loops are driving today's economy. When times are good, credit is ample, causing the economy to heat up. When the cycle shifts, lenders tighten standards and become more demanding about the collateral they hold, feeding into the negative-feedback loops hitting the economy.

He says shifts in this cycle can happen suddenly, catching investors and policy makers off guard. "When the world seems more uncertain, everyone wants a lot of collateral and the economy goes from highly leveraged to no leverage very quickly," he says.

"When things go bad, people have to sell assets to raise collateral," says Gregg Berman, co-head of the risk management unit of RiskMetrics Group. Selling reduces the value of the very assets borrowers have used as collateral against loans -- such as homes. "The more leverage is built into the system, the more the cascade effect is magnified," Mr. Berman says.

Individual banks might be acting rationally when demanding more or better collateral. Trouble is, when every lender does this at once, it becomes self-destructive, triggering shock waves that threaten the banks themselves.

The trick for policy makers is to break the loop. "A macroeconomic downturn tends to diminish the value of many forms of collateral...reinforcing the propagation of the adverse-feedback loop," Federal Reserve Governor Frederic Mishkin said in a January speech. Aggressive Fed interest-rate cuts help by reducing the cost of all of this borrowing.

The psychology of risk aversion behind these negative loops is hard to alter once it sets in. That is why breaking the chain this time could be harder than anyone expected.

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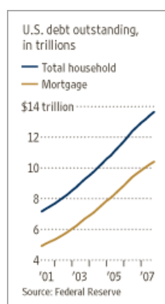

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