A Review of Atif Mian and Amir Sufi’s
House of Debt

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ABSTRACT

House of Debt by Atif Mian and Amir Sufi provides a pattern of large jumps in household debt and drops in spending preceding economic disasters. Based on national and international evidence, this book describes the way debt exacerbated the Great Recession, and also interprets the reasons why debt keeps on threatening the global economy, and what requires to be done to fix the financial system such as equity-like contracts.

KEYWORDS
Household debt; the Great Depression; House of Debt.

INTRODUCTION

As what American economist Lawrence Summer said, Atif Mian and Amir Sufi’s House of Debt, despite some tough competition, looks likely to be the most important economics book of 2014; it could be the most important book to come out of the 2008 financial crisis and subsequent Great Recession. Its arguments deserve careful attention, and its publication provides an opportunity to reconsider policy choices made in 2009 and 2010 regarding mortgage debt [1]. Atif Mian and Amir Sufi put forward a point of view in House of Debt accounting for why the Great Recession in 2008 occurred, which was that economic disasters are always preceded by a large increase in household debt. In addition, the authors provide domestic and international evidence to support this viewpoint. At last, what needs to be done to fix the financial system such as equity-like contracts are explained in this book.

This book is divided into three parts and twelve chapters. The three parts are: Busted, Boil and Bubble, Stopping the Cycle. Part 1: Busted, in which the authors’ views and evidence are provided to explain the Great Recession. Part 2: Boil and Bubble where authors show suggestions to reject some other ideas and interpret what bubbles are. Part 3: Stopping the Cycle, in which authors offer some advice to solve primary cause of financial crisis.

One of the authors, Atif Mian is Professor of Economics, Public Policy and Finance at Princeton University, and Director of the Julis-Rabinowitz Center for Public Policy and Finance at the Woodrow Wilson School. Professor Mian's work studies the connections between finance and the macro economy [2].

Another author is Bruce Lindsay Professor of Economics and Public Policy at the University of Chicago Booth School of Business. He was awarded the...
2017 Fischer Black Prize by the American Finance Association, given biennially to the top financial economics scholar under the age of 40. Professor Sufi's research focuses on finance and macroeconomics [3]. That the structure of this article afterwards is: the second part is the theory, the third part provides data support, and the last part is the conclusion.

THEORETICAL FRAMEWORK

From the evidence of countries all over the world, there is a strong pattern that economic disasters are always preceded by a large increase in household debt.

First, the author suggests that why debt plays an important role in accounting for economic crisis. If house prices decline, the mortgage lender has the senior claim on the house and they would be protected, while the house owner has the junior claim and suffers huge losses. The economists figure out that household debt mainly consists of mortgages and home-equity debt. Furthermore, people who are poorer would have less financial assets and more debts. Therefore, poor family, who are also the house owners, would experience great loss when house prices decline. What these households choose is either to stay in their homes, but owes the bank more than value of their homes, or to let the bank foreclose, which is the common choice of homeowners. After foreclosing, others would use the fire-sale price to assess the house price, resulting in housing market in worse condition.

And then, the author explains that, increasing household debt would lead to decreasing consuming. Poor household who own more debt have higher and more volatile marginal propensity to consume, so it shows that there is a positive relationship between the leverage ratio in the home and how much the household cuts back on spending when house values decline, that is, increasing household debt would lead to decreasing consuming, which is necessary for pushing economic crisis.

Next, the author proposes that descending consuming is essential for economic crisis happening. After consuming decreases, companies would get less profit. In order to maintain their business, companies managers need to reduce production cost through firing workers or lessen wage of workers. The previous one creates unemployment and the later one creates less consuming capacity. Either would make poor households cut back their spending, and then companies get less profit again, so it’s a vicious cycle. In the end, the unemployment rate will be at a high percentage, which is a typical characteristic of economic crisis.

Here is the flow chart of the whole model:
DATA

To support viewpoints suggested in the book, I found evidence from not only articles written by author Atif Mian and Amir Sufi but also from other journals about the Great Recession in 2008. The following paragraphs are corresponding to 1 to 6 in the flow chart one by one.

First, mortgages and home-equity debt made up 80 percent of all household debt as of 2006. Home owners in the bottom 20 percent of the net-worth distribution who are the poorest home owners were highly levered. Their leverage ratio, or, the ratio of total debt to total assets, was near 80 percent, while the richest 20 percent of home owners had a leverage ratio of only 7 percent. Besides, richest home owners’ net worth focused on non-housing assets. However, poorest home owners’ net worth was overwhelmingly concentrated in housing assets. That is, while the poor had $4 of home equity for every $1 of other assets, the rich were exactly the opposite, with $1 of home equity for every $4 of other assets, like money-market funds, stocks, and bonds [4]. Therefore, poorest home owners who are also borrowers already had less net worth before crisis and the concentration of losses on them when house prices decrease make them have even less. In contrary, the richest home owners who are also savers typically have lots of financial assets and little mortgage debt, experience a much less serious decline in their net worth when house decrease.

Second, according to Mian, Trebbi, and Sufi, aggregate foreclosure filings in the US increased from 750,000 in 2006 to almost 2.5 million in 2009. While they do not have data on foreclosures before 2006, the mortgage default rate increased above 10% in 2009, which is more than twice as high as any year since 1991. By any standard, the recent US mortgage default and foreclosure crisis is of unprecedented historical magnitude [5]. This evidence proves that there was increasing foreclosure, which is related to house bubbles during 2008 and 2009. This is because poor home owners didn’t have the ability to pay for debt so they chose to let banks confiscate their homes, which would be foreclosed by banks.
Third, as what Mian, Trebbi, and Sufi said in “Foreclosures, house prices, and the real economy”, the sharp rise in foreclosures has been accompanied by large drops in house prices, residential investment, and durable consumption. Nominal house prices fell 35% from 2005 to 2009. The drop in residential investment from 2005 to 2009 was larger than any drop experienced in the post-World War II era. The drop in durable consumption is also large, but more comparable to recent recessions [5]. Therefore, foreclosure not only leads to decline in house prices but also decline in investment and consumption. After foreclosed by banks, houses would be sold cheaply to compensate for the loan. Based on fire-sale prices, other home buyers and appraisers would estimate house prices in unreasonable prices. Therefore, house prices in certain regions would all suffer great loss.

Fourth, John Campbell, Stefano Giglio, and Paragon Pathak studied home prices in Massachusetts and estimated that foreclosure-related sales have prices about 27 percent lower than comparable properties. They also estimated that each foreclosure lowered the selling price of other (no foreclosure) properties within a radius of about 260 feet by nearly 1 percent [6]. In one of the first studies to examine the link between foreclosures and home prices, Dan Immergluck and Geoff Smith found something similar: their data showed that each foreclosure depressed the value of homes within 660 feet by 0.9 percent [7]. Although each foreclosure depressed home prices within several hundred feet by only around 1 percent, when there were a lot of foreclosed homes, the areas of homes would be much more than 660 feet. So the more areas of foreclosed homes are, the bigger effects are.

Fifth, a household with a loan-to-value ratio of 30 percent or lower in their home in 2006 had an MPC out of housing wealth as 0.01, and household with between 30 percent to 50 percent had an MPC as about 0.013, and household with between 50 percent to 70 percent had an MPC as around 0.017, and household with between 70 percent to 90 percent had an MPC as 0.025 or so. A household with a loan-to-value ratio of 90 percent or higher in their home in 2006 had an MPC out of housing wealth that was more than three times as large as a household with a loan-to-value ratio of 30 percent or lower [4]. MPC represents marginal propensity to consume. Household with higher MPC means it’s easier for them to change their consumption of goods and services based on wage. A household with a higher loan-to-value ratio always has a higher MPC, which means household whose net worth was concentrated in housing assets tended more to decrease their consumption of goods and services when they suffer great loss after house debt increased. Data provided by IMF proved that this point of view above is reasonable. Real consumption declines by more than 3.9 percentage points more in the high-debt busts, implying an elasticity of about 0.4, well above the range of housing wealth consumption elasticity in the literature (0.05–0.1). Based on this literature, the fall in house prices therefore explains at most one-quarter of the decline in household consumption [8]. The data from IMF shows that at most 25 percent of decreased household consumption was due to decreasing house prices. And high housing debt suggested more than 3.9 percent fall in real consumption.
Sixth, using a few technical assumptions, Mian and Sufi estimate that 4 million jobs were lost between March 2007 and March 2009 because of levered losses, which represents 65 percent of all jobs lost in sample. Besides, in the 20 percent of counties those were hardest hit by the decline in household net worth, the unemployment rate shot up from less than 5 percent to 13 percent during the Great Recession. It remained above 10 percent in the summer of 2012, three years after the official end of the recession [4]. The results of rising unemployment rate caused by the Great Recession during 2008 were so severe that impact remained until 2012. Moreover, according to Mian and Sufi, the unemployment rate in counties hit hardest by the housing crash is more than 3% higher in 2013 relative to 2006. The rise in the unemployment rate is twice as high as the rise in counties with the smallest decline in house prices. The housing crash has led to a large and persistent increase in unemployment [9]. This data shows that housing bubbles during 2008 resulted in an inevitable and serious rising unemployment rate.

Seventh, according to the paper of McKee and Varner which uses the variation across states in the UI expansion to estimate the consumption response to extended UI benefits, an additional week of UI increased household consumption by a statistically significant 1.68 percent. Consistent with the hypothesis that unemployed households are likely to be particularly liquidity constrained, this point estimate translates into a marginal propensity to consume out of UI benefits in the range of 0.59-0.91, which is larger than existing estimates of the consumption response to income transfers for all households [10]. UI stands for unemployment insurance. When UI benefits extend, that is, unemployment effects can be removed from unemployed people, household consumption increases by a statistically significant 1.68 percent means that decline in unemployment and raise in wage could both increase household consumption. And MPC out of UI benefits is larger than consumption response to income changes, which suggests that when unemployment effects are removed from unemployed people, compared with wage increase, households have more tendencies to increase their consumption of goods and services.
CONCLUSION

Atif Mian and Amir Sufi’s *House of Debt* provides new and reasonable viewpoints to make it clearer to understand the relationship between financial crisis and household debt. And data offered in the book strongly demonstrate that increasing household debt that is mainly housing debt forecasts financial crisis. Both evidence in America and other countries face financial crisis proved this framework.

Apart from contents from this book, more research should be done to explore the relationship between financial crisis and household debt. Although problems exist in financial system, equity-like contracts should be tried more to verify positive effects.

REFERENCES

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