

“Surviving Hard Times”

To help *JS* readers navigate through the complexities of the current credit crisis, we asked two Washington, D.C.-based economists, Melissa Wallace-Johnson and her husband, Nicholas Johnson, to help

explain it. Their answers are below. *[Note: Bolded words are defined in the skills reproducible “Money Talks.” See p. T-7 of the Teacher’s Edition. It is also available on our Web site.]*

Q. What are some of the key factors that led to the current economic crisis?

A. Over the past 10 years, the prices people were willing to pay for houses greatly increased. This led to what is called a bubble. In economic terms, a *bubble* is when the price of something increases too quickly because people believe the price will continue to rise.

When most people want to buy a house, they go to a bank [or other lender] to get a loan called a **mortgage**. As prices of houses kept increasing, banks created new [types of loans] to encourage consumers who wouldn’t normally have been able to afford a new home to buy one.

Usually, a new home buyer will make a down payment of 10 to 20 percent of the cost of the house and then take out a mortgage to cover the rest. Over time, often 30 years, this home buyer will make monthly payments to the bank to pay off the mortgage. However, with prices rising rapidly, banks began allowing home buyers to purchase houses without putting any money toward a down payment, and more home buyers were approved without a full evaluation of whether they were actually capable of making the mortgage payments.

At the same time, many home buyers purchased houses that they couldn’t afford. For example, a family that had a combined income of \$50,000 a year might be able to afford loan payments on a house that cost \$150,000. But the bank would allow them to take out a mortgage for a house that cost \$500,000.

Eventually, as all bubbles do, the housing bubble burst. People realized that there wasn’t any reason why prices had risen as fast as they had, so prices began to

decline. Also, buyers who had mortgages for more than they could afford started to get behind in making their payments. As fewer mortgage payments were being made on time, the banking industry started to lose a lot of money.

These losses began to spread rapidly throughout the global economy, because so many different types of investors had investments that were based on mortgages. *[See mortgage-backed security.]* This has led to what is considered a “credit crisis,” [in which] businesses, ranging from large to small, are having difficulty getting . . . loans that they often need to keep operating.

Q. Who is to blame?

A. There is no one group that is completely responsible. Banks [and other lenders] made loans that shouldn’t have been made, home buyers signed up for loans they couldn’t afford, the Federal Reserve Bank (which is responsible for controlling the money supply in the U.S. by changing the interest rate) maintained interest rates that were too low, and credit-rating agencies didn’t properly assess how risky mortgage-backed investments were. *[The interest rate is the yearly percentage charged on money that people borrow. For example, if you borrow \$1,000 at 5 percent interest, you would owe \$1,050 after one year.]*

Q. How is this crisis similar to the stock-market crash of 1929? How is it different?

A. The only similarity is how it began: In the 1920s, the stock market became a bubble as people thought stocks would continue to rise forever at unsustainable levels. Not only were people investing money they had, but

they were investing money they were borrowing. When the bubble burst, economists weren't as knowledgeable as they are today about taking the proper steps to contain the problem.

Fortunately, economists learned a lot about the mistakes that created the stock-market crash of 1929 and the resulting Great **Depression**. This leaves us much better prepared to minimize the effects of this economic crisis. Furthermore, as a whole [the nation is] far wealthier than we were in 1929, which makes a loss like this easier to absorb.

Q. What is Congress's economic bailout plan designed to do?

A. The **bailout** plan is intended to provide a buyer [*the government*] for the mortgage-backed investments that are failing. Right now, people are reluctant to purchase these investments because their value could continue to decline. If no one buys them, there is a strong possibility of a number of large companies going out of business. In the bailout plan, the U.S. Treasury would have authority to use up to \$700 billion to purchase these mortgage-backed investments.

To get an idea of how much money this is, you could buy about 14,000 commercial airliners for it.

Q. What is the best and worst that could happen as a result of the plan?

A. The best thing that could happen from the bailout is if the U.S. Treasury is able to turn a profit from the investments it purchases. If the value of these mortgage-backed investments rises, then the bailout will lead to a profit for the government. However, if these investments continue to decline in value, the government will eventually have to make up these losses by increasing taxes.

Furthermore, the bailout sends the message to companies that they can behave recklessly and still not face the full consequences of their actions.

Q. Do you think we are headed for a long recession? Why or why not?

A. It's very difficult to predict the duration or the severity of a **recession**. In fact, we're not even in a recession yet. By definition, a recession is two consecutive quarters of negative growth in the production of goods and services in the U.S. If we do enter a recession, it's definitely not a time to panic. There is no reason to think that we will face anything close to the Great Depression of the 1930s. Recessions are a necessary part of the business cycle, because they help to reallocate money to more efficient businesses. Just eight years ago, the U.S. economy went through something similar when the tech bubble burst, and [the country] survived that just fine.

Q. What should ordinary Americans do to help protect themselves against economic hard times?

A. The key to surviving hard times is to properly prepare during good times. It is important to save money to ensure that during times when you might have lower pay or higher expenses than normal, you can cover this difference with savings. Some of the most important lessons about money and life can be learned in tougher economic times. Learning how to cut out coupons, turning off lights when you leave a room, and saving part of what you earn are examples of some things that you can do at all times to help save money.

Also, keep in mind that when the stock market is "falling," that means stocks are at low prices. If you have a little extra money saved up, it is a great time to buy some investments. They will grow [in value] when the economy turns back around. **JS**