Mortgage Securitization in the 1920s

[This is a letter I sent out to my "Hi everybody" email list on April 28, 2010.]

Hi everybody,

Even on the left, most of the attention that has been focused on the current economic crisis has been with regard to the initial financial aspect of it, and in particular the Wall Street panic of late 2008 resulting from the (partial) collapse of the housing bubble based on sub-prime mortgages and extremely dubious securitized mortgage debt (Collateralized Debt Obligations, etc.).

I have been arguing that this crisis is in its overall essence a classic *overproduction crisis* as analyzed by Marx, and that the financial crisis aspects of it—though certainly serious and even very dramatic at times—are merely surface eruptions ultimately resulting from a much deeper economic contradiction (i.e., the extraction of surplus value from the workers). This has led several of my friends and correspondents to claim that I am neglecting the importance of the financial sphere in modern capitalism.

Their implication is that this crisis is indeed primarily a financial crisis, and—since a financial recovery has been in progress for a year or so—that things are now on the mend, at least for the next several years. The 2008 panic is over, and therefore—despite very high lingering unemployment—the recession is either over, or at least soon will be. And there is not going to be a second great depression, at least any time in the foreseeable future. So the thinking goes.

One of the major premises in this argument is that while financialization has been a part of capitalism for the past century (i.e., during the entire capitalist-imperialist era), it has over the past few decades not just grown relative to past decades, but has actually made a qualitative leap into something quite new. I don't dispute that in recent decades the financial sphere of the U.S. and world economies has indeed expanded tremendously; but I do dispute that it is something qualitatively new, or that it changes the basic nature of the beast, or the basic nature of the economic crises which develop within it.

If you look at Lenin's 1916 pamphlet, "Imperialism, the Highest Stage of Capitalism", you will find a great emphasis on financialization of capitalism in the imperialist era. (Lenin followed Hilferding's 1910 book, *Finance Capital*, in this regard.) That has been part of the conception of capitalism in the imperialist era all along!

That's true, my friends admit, but then argue that there have been so many new developments in the financial sphere that we really must look at modern financialization as something qualitatively new and different.

But what new developments in particular do they have in mind? Well, just things like we've been talking about, such as sub-prime mortgages and securitized mortgages and other derivatives. These are imagined to be quite new developments. But this is where a failure to adequately understand the past gets them into trouble. In actual fact things like bad mortgages and securitized mortgage debt played a quite prominent role in the financial crisis at the beginning of the Great Depression of the 1930s as well (though more so with commercial property than private homes). This is something that is not widely known!

The article below brings this out fairly well. It is from the new issue of the *NBER Digest* published by the bourgeois economics organization, the "National Bureau of Economic Research". I especially recommend this article to those who think that financialization of capital is something very new!

An additional point to make here is that while a financial crisis usually is a prominent event during the early stage of an overproduction crisis, *additional episodes* of financial crisis can also erupt as the overall crisis continues to develop. Thus, even though Wall Street gambling houses are fairly stable at the moment, we currently have a new financial crisis in Europe looming over the unsustainable national debt in Greece, Portugal, Spain, Ireland, etc. Even if that is brought under control for a while, there will be new eruptions of financial crisis from time to time.

We are in a period of the ***great unwinding*** of the U.S. and world economies that will be continuing for at least several years. That means new financial shocks from time to time as the world capitalist economy sinks toward a new depression.

Scott

From: *NBER Digest*, May 2010, online at: http://www.nber.org/digest/may10/may10.pdf

Securitization in the 1920s

Real estate bond issuance, which accounted for nearly 23 percent of all corporate debt issued in 1925, fell to just 0.14 percent of the debt market by 1934 and some days no bonds traded. The real estate bond market soon vanished.

The financial innovations that propelled the boom and collapse of the commercial real estate securities market in the last decade parallel those of that same market in the 1920s. Issuance of commercial mortgage-backed securities financed the construction of most of the U.S. skyscrapers in the 1920 and led to overbuilding and then widespread vacancies. The price declines in the mortgage-backed securities market in the late 1920s preceded the crash of the equity markets and the start of the Great Depression. Analyzing the events of the earlier crisis can provide insights to regulators and financial institutions struggling with solutions to the current one, according to William Goetzmann and Frank Newman, co-authors of **Securitization in the 1920s** (NBER Working Paper No. 15650).

The authors observe that "by nearly every measure, real estate securities were as toxic in the 1930s as they are now." Widespread economic optimism after World War I fueled demand for office space, boosting average commercial rents nationally 168 percent from a pre-war base through 1924. That kicked off a speculative commercial real estate construction boom not matched until the mid-2000s.

New York and Chicago were the primary focus of the real estate run-up. More office buildings taller than 70 meters were constructed in New York between 1922 and 1931 than in any other ten-year period before or since, according to the authors' research. "These 235 tall buildings represented more than an architectural movement; they were largely the manifestation of a widespread financial phenomenon." That is, the speculative construction meant building for the express purpose of maximizing rents in buildings with multiple tenants in order to turn a profit. Before that time, office buildings were financed and built by companies primarily for their own use.

In order to feed the demand for capital to finance construction, bond sellers courted retail investors, selling them shares in these commercial ventures as well as bonds backed by the properties -- a precursor to the modern markets' complex forms of securitization. Previously, only institutional investors, such as banks and insurance companies, were the sources of such funds.

Demand was such that a real estate securities exchange was created in 1929 and commercial mortgage-backed securities quickly grew into one of the largest classes of investment assets of the 1920s, raising more than $4.1 billion from 1,090 bond offerings between 1919 and 1931. Among the reasons for this rapid growth was the presence of small investors who, it turned out, relied on poorly supported assertions of asset value provided by a few large intermediaries in a market with little centralization or regulatory oversight. "The public was the obvious but critical third party in the real estate securities boom of the 1920s," Goetzmann and Newman write. "It is not clear whether building companies viewed the public as an attractive (if ignorant) source of capital or as a lender of last resort. Anecdotal evidence suggests the latter, as do the empirical results of this study."

At the market's peak in May 1928, bonds sold at 100.10, a premium versus par, according to a commercial mortgage price index the authors created to track the coupon yield spreads on real estate bonds for the decade 1926-35. But rampant development based on easy access to capital led to massive overbuilding and then empty structures, which eventually led to defaults and finally a widespread collapse in bond prices.

Significantly widening yield spreads on real estate bonds versus Treasuries began in December 1928, nearly a year before the stock market collapsed in October 1929. By April 1933, bond prices fell to a low of 24.75 cents on the dollar. And by 1936, at least 80 percent of the outstanding securities issued between 1920 and 1929 were failing to meet their contracts, resulting in widespread defaults. Recoverable value on those same issues ranged from approximately 80 percent for 1920-vintage bonds to less than 40 percent for 1928-vintage bonds.

Real estate bond issuance, which accounted for nearly 23 percent of all corporate debt issued in 1925, fell to just 0.14 percent of the debt market by 1934 and some days no bonds traded. The real estate bond market soon vanished, as did many of the bond houses that created them, among them many of the most trusted names on Wall Street. That was followed by public outrage over institutional corruption.

"Ultimately, the size, scope and complexity of the 1920s real estate market undermined its merits, causing a crash not unlike the one underpinning the nation's current financial crisis, due in part to a commercial construction boom matched only in the mid-2000s," the authors say. "These analyses allow us to conclude that publicly-issued real estate securities affected real construction activity in the 1920s and that the breakdown in their valuation, through the mechanism of the collateral cycle, may have led to the subsequent stock market crash of 1929-30."

—Frank Byrt