House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again

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House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again
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The House of Debt captures an interesting theme that links the financial crisis of 2008 with the household debt and particularly the mortgage debt. This work constitutes a detailed analysis of the latest financial crisis and provides all the necessary tools in order for us to be prepared in future similar cases. The book explores how a sharp increase in household debt and the subsequent reduction in consumption led to the Great Recession and Great Depression, as well as the current economic problems in Europe.

Professors Mian and Sufi focus on the problems created by macroeconomic effects of private debt beyond the absolute trust on the established economic belief that the banking sector’s downfall caused the recession. They employ a comprehensive analysis of the data throughout the crisis period and before in order to learn from the past and prevent same situations from happening again. Therefore, through a detailed analysis that is based on empirical data Mian and Sufi argue about the implemented policy choices.

The work is divided into three main parts that include the general description of the recession, the debt and bubbles and the proposed approach to prevent it from happening again.

The first part illustrates the consequences of the economic recession, such as job losses, collapse in consumption and wealth inequality. The fundamental idea is the understanding of debt’s role in the financial system. Severe economic declines seem to be almost always preceded by an up rise in household debt. By using a collection of facts from the recent economic history Mian and Sufi uncover the mechanism that leads to these economic contractions.
They focus on the important role of household debt. A levered-losses framework is used to describe the way that debt distributes losses when asset prices like home values drop down. During the recent contraction debt has to distribute losses when asset prices like home values collapse. They also support the theory that the simultaneous collapse in consumption does not seem to be independent from the Great Recession and prove that debt is a critical input in the decrease of consumption. Debt leads to severe economic contractions and both the Great recession and the Great Depression in United States were preceded by a sharp rise in household debt and a collapse in asset prices. This pattern is explained by the authors under a levered-losses framework. The main inputs in this framework are differences across the population due to debt and a shock to the economy.

The second part presents the credit expansion and the science of bubbles. They treat the growth in debt and the house-price bubble in the United States as a cause-and-effect challenge and they observe that the growth in house prices must be sparked by the large increase in lending and not the opposite.

Finally, the third part starts with an interesting insight on the Government Saving the banking system policy. There is a detailed description of the Spanish mortgage law that it is extended on the banks in the United States during the Great Recession. They present evidence against the banking-lending view and they do not want to focus on the banking crisis. They do not turn down the banking-lending view but they focus on the household-debt burdens that drove the Great Recession. They believe that a better approach to save the banks would have been to focus on the household-leverage problem.

Except of the observation of the factors and facts that lead to severe economic crisis, the book provides the reader with proposed tools to prevent similar cases in the future. They conclude that the major problem is the inflexibility of debt contracts. They introduce the more equity-like contracts as a better risk sharing for the entire economy. The sharing of the risk would help to avoid prospective bubbles and make their crashes less severe. Under this case the monthly mortgage payment should be reduced proportionally if housing prices fall and otherwise if prices increase, the lender gets a share of the premium. This concluding proposition is a shared-responsibility mortgage. This mechanism is presented as a solution to the levered-losses problem and indicates that a more equity-like financing system can help prevent obdurate recessions and promote feasible economic growth.

Taking into consideration that the recent financial crisis is a highly debated subject worldwide, this book is the cynosure of a broad readership. The intended audiences, besides the academic community and policy-makers, might be every person with concerns about the general economy and financial cycles. I believe that this is the reason why the authors tend to use a very analytical way of writing that is simple, direct, concise and to-the-point. What distinguishes this book is that it goes beyond a simple description of the crisis and suggests possible alternatives to prevent same recessions in the future. The authors try to avoid classical economic beliefs such as the bank-lending view in order to focus on the household-debt crisis that was ignored by a lot of economists. The work is very well written and clearly argued by using a lot of examples and data to support its conclusions.

The conclusions concern not only the United States, but many other countries with the same financial difficulties. Specifically, there is a detailed reference in the Spanish mortgage problems and its banking system as an example that proves the failure of the concept that protecting banks at all costs is enough to save the economy. A very interesting application of the proposed sharing risk principle is that European countries with particularly high debt burdens, suffered a much worse recession than the countries which had been lending to them. This is justified due to inflexible debt contracts, which forced losses on debtor countries while creditors remained protected. The proposed levered-losses framework applies directly to the international system just as it does within the United States.

Although I believe that the authors’ solution about a shared-responsibility mortgage is an interesting idea and well formulated, it is difficult to be implemented in the current financial system.
It is a very new and innovative idea which can put thoughts into our minds for the future of the global financial system.

In summary, the present book is a positive contribution to the recent recession bibliography. This book is well written and timely. I like the fact that Mian and Sufi do not limit in the sole presentation of the historical facts but they move a step forward to the justification and proposal of a proposed theory in order to prevent similar recessions in the future. Another interesting point that could diversify their work is the focus on the housing-debt. Growing household debt leads to foreclosures and decrease in consumption. This leads to less demand for goods, followed by less production and unemployment. The above principle cause their direct interest to focus on debt and propose a financial system released from its reliance on inflexible debt contracts.

Overall, this book is an excellent overview of a major issue of interest in the modern economy about the rising housing debt and the subsequent severe recession. We are all interested in any implemented policy recommendations that are based on historical facts. One can only hope that the book is widely read, and its lessons are taken to heart in order to prevent same situations in the future. This book is worth reading as a presentation of the impact of debt in consumer behavior during the recent housing bubble, as well as an expansion in serious empirical evidence and policy recommendations. I warmly recommend The House of Debt to the readers.

Kyriaki Begiazi is a recent PhD graduate of the Hellenic Open University. She holds an MSc in Finance from Athens University of Economics and Business and a BSc in Economics from the same university. She is an Economic and Financial professional with a record of accomplishment in banking, consulting and financial analyzing in major corporate environments. Her research interests lie in the areas of Applied Econometrics, Time Series Analysis, International Economics, Finance, Real Estate Investment Trusts.