The fate of the economic recovery, we are often told, rests in the hands of American households. If they are confident, they will spend and invest, boosting growth. But if they remain uncertain and anxious in the aftermath of the financial crisis, they could hunker down and take the economy with them.

Which way will households go? There are few better authorities on that question than Karen Dynan—although she will be the first to tell you that there is no straight-forward answer.

As co-director of economic studies at the Brookings Institution, Dynan spends much of her time thinking about the interplay between the wider economy and US consumers. A prolific author, her contributions are well known in the academic world of household finance, her papers having appeared in publications that include the *Journal of Economic Perspectives* and the *American Economic Review*. She has testified before Congress, published articles on how the household debt overhang holds back consumption, and written for the *Washington Post* and the *Financial Times* on issues ranging from Federal Reserve policy to myths about Black Friday (myth number 2: Sales on Black Friday make or break retailers’ holiday shopping season).

Mark Sniderman, the Cleveland Fed’s executive vice president and chief policy officer, interviewed Dynan on November 9, 2012. She was visiting Cleveland to discuss her research and views with Bank economists and senior leadership. The following interview has been edited and condensed.
Sniderman: I want to start by asking you a little bit about being an economist. When did you first know that it was the career for you and, along the way, what have you learned about the profession?

Dynan: I discovered the field of economics in college. I’d always been good in math and sciences and statistics, but I really wanted to do something to help people. When I took my first economics class I knew it was right for me because it gave me a chance to use my skills, but also it provided a wonderful way to help people by affecting public policy. That was really what whetted my appetite.

Later, after college, I went on to become a research assistant at the Federal Reserve Board, working on monetary policy, and that was just such a wonderful experience, being able to learn about monetary policy, understand the ways in which it affects the economy. So that is when I decided to go to graduate school to become an economist.

Now, in terms of what I’ve learned along the way—and I’m still learning—the number-one lesson is that economics is really hard. The world is a complicated place and when you’re given your formal training, you’re often told to describe the world using these very simple and stylized models. The entire Federal Reserve System might be described by the letter p for prices and m for money. But you know, as I’ve gone on to work in policy and particularly as we have lived through this financial crisis and tried to use policy to respond to the crisis, I’ve learned that the world is far more complicated. There are constraints and incentives that people and businesses and financial institutions face that are far more complicated than any economic model will tell you. You have to think about all these things as you are setting policy.

Sniderman: Your having answered that question that way makes me nervous to ask you the next one, because I’m giving you just a few minutes to deliver a very complex analysis. Coming through the worst financial crisis since the Great Depression, what do you think we have learned and should have learned? And what are the lessons for public policy and for economics?

Dynan: It was a period when some pretty big mistakes were made and there’s lots of blame to go around. The roots of the financial crisis were in the fact that too much risk was being taken. Too much risk was being taken by households. Too much risk was being taken in the financial system by financial institutions—banks, investors. Regulation didn’t do what it was supposed to do. It didn’t recognize the risks as they were building up.

Things might have worked out okay if the housing bubble hadn’t burst, but in fact it did burst. And that caused a lot of these risks to come home to roost. People suddenly found themselves with mortgages they couldn’t sustain. Financial institutions found themselves exposed to losses that they didn’t expect because they didn’t understand how much risk they had been taking.

Sniderman: What’s your take on the way that we as a nation have responded to the crisis legislatively?

Dynan: I think that it’s pretty clear what direction we needed to move in. We needed to move in a direction that put in place a regulatory system that was better able to protect people and protect financial institutions from excessively risky behavior. We’ve redesigned regulations and, yes, the laws are complicated. That’s not surprising—the financial system is very, very complicated. Nobody wants unnecessary and burdensome regulations. I think the regulatory community understands that. But the challenge is going to be how to get the right amount of regulation, given how complicated things are. A lot of it is still being worked out. They’re still studying exactly how we should implement these laws. And I think that’s very appropriate, given how hard the problem is.

If you think of credit supply as a pendulum, we had swung way too far in one direction, in the direction of easy credit during the lead-up to the financial crisis. And now we’ve swung way too far in the other direction.

What you’re looking for is a balance. You’re looking for the right amount of regulation, such that credit can still flow and people and businesses can still enjoy the benefits of credit while being protected against the worst abuses associated with credit and reducing the exposure of the system to the kind of meltdown we saw during the financial crisis. That is going to be a hard balance to achieve. And I think regulators need to study the problem, they need to try to work out the solution, but they also—after we’ve put in place the solution—they need to continue to study the problem. They need to see whether we’ve gone too far. They need to be ready to be responsive to that.

Sniderman: Are there aspects of all the regulations that have been put in place that even today you would look at and say, gee, maybe we’ve imposed too much red tape or too many complications?

Dynan: I think in many senses it’s too early to know. What we do know is that, if you think of credit supply as a pendulum, we had swung way too far in one direction, in the direction of easy credit during the lead-up to the financial crisis. And now we’ve swung way too far in the other direction. Credit is still very hard to get and that’s holding back the economy.
Karen Dynan

Position
Vice president, co-director of economic studies, and Robert S. Kerr Senior Fellow at the Brookings Institution

Former Positions
Economist and staff adviser at the Federal Reserve Board
Senior economist at the White House Council of Economic Advisers
Visiting assistant professor at Johns Hopkins University

Education
Harvard University, PhD in economics
Brown University, AB

Selected Publications
"Is Household Debt Overhang Holding Back Consumption?"

"How We’re Doing as Debt Fears Rise,"


Now, we don’t know exactly why. We don’t know if lenders don’t want to lend because of the normal caution that comes with a weak economy or whether it has something to do with the new regulations. That’s something that we’re going to have to study over time. There’s also the whole issue of the uncertainty about future regulation. The Dodd–Frank law is still being implemented and there are parts of it that still require the details to be written down. I think it’s very hard for financial institutions to design their lending strategy until that’s all worked out.

Sniderman: There are differences of opinion among some economists about how to think about regulation. There are some who—to paint the extremes here—say that all we need for markets to work effectively is transparency and disclosure; you want to provide good instruction manuals and provide warnings and tell people how to use these products, but after that it’s caveat emptor. You don’t get into this nanny state with consumers. Other people have the view that people in certain instances are just going to make bad choices. You should prohibit certain products; you should prevent people from harming themselves by outlawing and regulating. Have you formed any views about that tradeoff?

Dynan: One important lesson that we’ve drawn from the financial crisis is that there are real limits to people’s capacity to process information. The fact of the matter is that managing one’s finances is really complicated.

It’s complicated even for people like me with training in economics, and I’m married to an economist [Douglas Elmendorf, director of the Congressional Budget Office]. I know how complicated these decisions are. I think it’s been a real lesson that we shouldn’t just emphasize providing information.

During the run-up to the financial crisis, people signed on for mortgage products that I’m sure had ample paperwork describing what the payments would be and how the payments might adjust as, say, interest rates moved. But I think we’ve seen evidence that many people didn’t really understand that that’s what they were signing up for. What this tells me is that it’s not just about providing a lot of information; it’s the type of information you provide.

So we really need to think about designing simple, low-cost products that are easily understood by a wide range of the population. I also think we can learn from behavioral economics. Oftentimes when people don’t have the time or ability to understand a complicated financial situation, they take cues from their peers, or from their employment, or even from what they’re seeing on TV. That’s taught us that it’s very important how you set up the defaults of any kind of situation. We need to think harder about what the baseline offering is, because I think people will take that as a piece of advice that, yes, this is a good financial product.

Sniderman: One of the other things that has come up in the aftermath of the financial crisis is a rethinking of housing finance. With the government-sponsored enterprises Fannie Mae and Freddie Mac scaling down, how do you think about what we should be doing with housing policy?

Dynan: Let me start with Fannie and Freddie. The financial crisis illustrated that our pre-crisis housing finance system—which was dominated by Fannie Mae and Freddie Mac—really had severe deficiencies that ended up leading to too much risk in the financial system. In thinking about how we should reform these entities, three principles come to mind.

First of all, I think we need explicit and limited government guarantees for mortgage loans. In the old system, the guarantees were implicit and essentially provided a subsidy to Fannie and Freddie that incentivized them to take on too much risk. So I think we need to move towards guarantees on loans that are explicit and priced to correctly reflect the risk of the underlying loan.

The second principle that I think we need to keep in mind is that securitization really needs to move back into the private sector. Fannie and Freddie have been in conservatorship since 2008, which essentially means that the government has been doing all of their activities, both securitizing the loans and guaranteeing the loans. While I think the government should continue to be a guarantor of certain loans, the securitization activity really should move back into the private sector. This signals that we’ve learned from the crisis and should change the role of government in housing finance.
sector because the private sector is going to be more efficient at it and is more likely to innovate in ways that save money. And when it moves back, we need to move it back in such a way that there’s not just one or two institutions dominating the whole market, because in that situation you would end up with entities that were too big to fail, which would lead to excessive risk-taking.

**Sniderman: The status quo.**

**Dynan:** Right. The third principle is that we need to get a plan in place as soon as we can. Not that we need to move to the new housing system as soon as we can — the housing market is still in a lot of trouble and maybe it’s right for the government to have such a large role right now. But we need to get the plan in place, because right now the situation we’re in is kind of housing finance limbo. It’s very difficult for lenders to go about their activities making mortgage loans when they don’t know what the future mortgage finance environment is going to be. It makes it very hard for them to make loans today, and it makes it hard for them to strategize about the future.

**Sniderman:** I think we’ve seen in other realms, as with the Basel accords, when they set these new standards, they typically give these long phase-in periods. I think you’re saying, let’s give people a flight path to where we’re headed and a time frame.

**Dynan:** Yes. I think it would make it easier for everyone to plan, to know where we’re headed.

**Sniderman:** What are your thoughts about the scale of this? You said we should let securitization become private, but the guarantee system could remain public. Would there be more limited types of guarantees to all forms of owner-occupied housing?

**Dynan:** One question that’s still under debate is whether we need these guarantees in order to have 30-year, fixed-rate mortgages. If you look across countries, for example, the 30-year, fixed-rate mortgage mostly is a product that’s seen in the United States. Some people would argue that is because we have these guarantees on mortgages. So maybe that’s an argument for having guarantees. More importantly, we need to have the capacity to do enough guaranteeing so that we can keep credit flowing if the mortgage market seizes up again.

I also think the guarantees should be limited. One of the biggest problems we had was that the risk wasn’t priced correctly in the run-up to the crisis. Pricing risk is very hard. If you want to price risk correctly, you need to keep the situation as simple as you can. I think we’re going to want to limit these guarantees to simple, transparent mortgage products with clearly defined parameters.

**Sniderman:** It’s commonplace for people to say that we had too much emphasis on owner-occupied housing leading up to the crisis and now we should support a more balanced housing system between rental and owner-occupied. Is that sensible or not?

**Dynan:** I think it’s very tough to know what the right level of homeownership is for our country. The experience of the past few years suggested that there are certainly limits to how far you want to push it. At the same time, I think there are clear benefits of homeownership. The evidence suggests that putting down roots in a community can benefit the whole neighborhood. On top of that, a benefit of homeownership is that homes still represent a form through which consumers can build assets. I want to qualify that very carefully. In the period leading up to the financial crisis, the mistake was that people thought they could build assets effortlessly by just waiting for their homes to appreciate. We learned that that was a very bad assumption.

But I do think homeownership can help a household build assets through a more traditional financing model, where you have to make a down payment and where you have to make payments that pay off principal, so that you’re building equity in your home.

**In the period leading up to the financial crisis, the mistake was that people thought they could build assets effortlessly by just waiting for their homes to appreciate.**

The equity is not locked off; you can still get at it through a refinancing transaction, but it takes some work to get at it. I think that actually could be very useful for households that have trouble saving because they have trouble planning or they have self-control problems.

Over the longer run, I think that means we need a system that not only emphasizes homeownership but also puts weight on creating good rental housing for households for which homeownership is not the right choice.

**Sniderman:** Recently you’ve looked at this deleveraging process that’s under way. I wonder if you can talk about that a little bit. How far along in the deleveraging process might households be?

**Dynan:** We have seen considerable deleveraging for the nation as a whole. If you look at household debt for the entire economy, relative to income for the entire economy, you can see that that ratio has fallen back to its level as of 2003. So it sounds pretty good, but I think it’s very important to look beneath that aggregate figure and see what’s going on for different types of households. As it turns out, the deleveraging has been concentrated in certain groups.
One group would be the people who defaulted on their mortgages. They had loans that proved unsustainable and they defaulted on those loans so they no longer have that debt any more. Those households have managed to do quite a lot of deleveraging. There’s a sense in which those households are in a better financial position today as a result. They don’t have the burden-some debt obligations that they were finding so hard to sustain. That’s probably a plus for their situation. That’s not to say that they came by it costlessly. In many cases, they lost a home, they were displaced from their community, and, going forward they’re going to have limited access to credit, which is going to make it hard for them to get through periods when their income is temporarily disrupted. But, when all is said and done, these households did deleverage very dramatically.

Another portion of the decline in household debt in the nation as a whole has to do with reduced new borrowing — people just not taking out loans that they otherwise would’ve taken out. There are probably two things contributing to this. One is that people don’t want to borrow much when the economy is weak because they don’t want to spend much when the economy is weak. So some part of it has been by choice. But another part of it has been forced upon households. Lenders are being super-cautious right now. We can look and see they are requiring higher credit scores and better documentation of income than they did prior to the financial crisis.

For many of those households, consumption is below what it otherwise would be. But the good news is that as credit conditions ease, we’ll probably see households’ consumption rise, which would be a good thing for the economic recovery in this country.

The last group of households I think about are those highly leveraged households that didn’t default. Those are the people who ran up a lot of debt prior to the financial crisis and so have high debt obligations. On top of that, many have seen their home prices fall dramatically, which has put many of them underwater with their mortgages. I’ve researched this group of households and it looks to me that unless you defaulted, you probably haven’t made a lot of progress deleveraging. You just haven’t found a way to really pay off that debt very aggressively, such that the distribution of leverage for the highly leveraged households is pretty similar to where it was a couple of years ago. These households have spending that is very constrained by their situation. And that’s the group of households that we need to worry about and we need to think about what we can do to help.

Sniderman: In the earlier days of the crisis, there were some voices calling for much more expansive and innovative kinds of programs. Do you think those things would’ve worked?

Dynan: Of course, it’s hard to say for sure, but there are some things we do know. Some programs, at least in their early form, had flaws. It turned out that mortgage servicers faced constraints that people who designed loan modification policies didn’t really understand. That really limited the degree to which they could modify mortgages to make them more sustainable for borrowers. I also think that the earliest forms of the program were limited in their scope. Much of the thinking that went into the government’s largest mortgage modification effort occurred before we saw labor markets deteriorate. Those programs helped people in certain situations, but they actually were not targeted towards people who needed a very large amount of help over a short period, as a homeowner who has lost her job might. So the programs fell short in that way.

Sniderman: Looking ahead, we have some demographic changes: Our population is getting older. Most studies say households are not very well prepared for their older years. It seems to be difficult to figure out, from a financial-education point of view, how to get households to do better financial planning and increase their savings. Do you have any insights about that?

Dynan: The issue of saving is really important. We know that for the nation as a whole, personal saving is up from where it was prior to the crisis. But again, it’s a question of how that is spread out. Is that increase just a few households doing a lot more saving, or is it broadly spread across the population? We don’t have the kind of data at the household level to answer that question because the data sources you would use are usually released with a lag, so we can’t look at them yet.
For the lowest-income households, financial security. I'm a fan of that.

to its employees about what would be and effectively providing some advice unless the employee opts out. So the
employee doesn’t have to participate, but the company is creating a default employee's retirement account for their employees, unless the employee opts out. So the employee doesn’t have to participate, but the company is creating a default and effectively providing some advice to its employees about what would be good from the point of view of their financial security. I’m a fan of that.

For the lowest-income households, I am very intrigued by programs that provide some sort of match to incentivize saving. If households do a certain amount of saving, either the government or some other source will match their savings in order to incentivize them to do yet more saving. I think those ideas are very interesting and we should be piloting and studying these sorts of programs.

Sniderman: Is it just that society has changed or is there something different about the saving habit?

Dynan: The issue of a cultural shift is a really interesting one, and people love to tell the story that our grandparents lived through the Great Depression and were enormously thrifty ever after.

We haven’t seen that kind of thriftiness in today’s generation. We see people much more focused on keeping up with the Joneses. That said, we don’t have great evidence as to whether a cultural shift might be occurring. Certainly a lot of people are now asking whether, having lived through what we lived through over the past few years, we’ll see renewed interest in thriftiness for the folks that faced a lot of hardship.

Sniderman: Speaking of our nation's ability—or inability—to plan ahead, what are your thoughts about the fiscal crisis? What should we be thinking about there?

Dynan: One thing that’s been a source of frustration for monetary policymakers is that the steps they’ve taken have been constructive for the economy, but they’re by nature limited. They can’t support the economic recovery by themselves. They need fiscal policy to play a role as well. The challenge there has been designing steps that will support the economy over the short run but contain debt and deficits in the longer run; if you take the first part and not the second part, you create a lot of uncertainty about what the future holds, which will hold back the economic recovery. I think we’ve seen a lot of dysfunction in Washington that’s stood in the way of making smart fiscal choices. I hope that we’ll be able to overcome that.

Sniderman: Part of your career was working for an economic policymaking organization [the Fed] and you had a career partly as an academic, and now you’re at what's popularly called a think tank. How does working as an economist differ in these settings, and what kind of satisfaction do you get and what challenges do you find in these places?

Dynan: Universities are the traditional career choice of economists, and I think they are a great place to engage with students and to pursue research in an incredibly intellectually rigorous environment. But I do think that anyone who is very interested in policy should consider working for a government agency or for the Federal Reserve System. Besides the generally rewarding aspect of public service, these institutions are places where you really can have a direct influence on the policy leaders who are making important decisions, and that can be very rewarding. That’s certainly what I found when I was working for the Federal Reserve Board just after I left graduate school.

I think we’ve seen a lot of dysfunction in Washington that’s stood in the way of making smart fiscal choices. I hope that we’ll be able to overcome that.

I would say that think tanks also play an incredibly important role in the policy sphere. You don’t have the direct connection with policymakers, or as much of a direct connection as you would at a government agency or the Fed. But the activities and the research that is done at think tanks are incredibly important.

One big difference for me now is that I come into contact with a far broader range of people as I do my research. I spend time talking to business leaders, to people who work at consumer groups, and to people who work at international agencies, and also I spend time with the general public. I think this kind of exposure has led me to understand far more about how the world really works than I had previously. That’s been very good for my research. It means that my research offers a perspective to policymakers that they’re not necessarily going to get from inside their institutions. ■