American Enterprise Institute for Public Policy Research

June 2008

On the Issues

It's Only Going to Get Worse

By Lawrence B. Lindsey

The housing market crash is far from over, says Lawrence B. Lindsey, and its ending is hard to predict because so many of its features are unique. A dose of modesty about what is ahead is called for in this situation. Lindsey sketches what parts of the solution may look like and says that policymakers need to remain flexible about actions that may be needed to augment the normal functioning of the market.

America has not had a nationwide housing crash since the 1930s. At one point during that calamity, an estimated 60 percent of all mortgages were in technical default. The rather primitive housing credit system of the time, which relied on five-year balloon mortgages, certainly exacerbated the problem, but the bulk of the problem was related to the general economic downturn. There have been some regional housing crashes that were short and relatively mild, most notably in California, Texas, and New England in the late 1980s and early 1990s. Most of those were caused by declines in key local industries: oil in Texas, aerospace and defense in Southern California and Massachusetts.

The current downturn, by contrast, is due almost exclusively to a change in the housing credit cycle from excessively easy to modestly restrictive. Housing turned down before the economy, and even now, nearly eighteen months into the housing recession, the national unemployment rate is still at what economists consider full employment. That is unlikely to last as credit problems spread into the consumer sector, layoffs spread, and the resulting rise in unemployment makes the consumer credit situation still worse.

It is the uniqueness of the current housing crash that adds to its intractability. Policymakers have not been here before, so they are not certain of the way out. Many of the institutions that underpin the industry are relatively new—actually created since the last downturn in the early 1990s—and untested. We also know that many of those institutions were far from transparent, and some were fraudulent. As a result, everyone needs to be suitably modest about predicting how the housing crash will end and remain flexible about the policy actions that may be needed to augment the normal functioning of the market. Some basic facts about supply and demand offer a good, if sobering, place to start.

Some Facts about the Housing Market

There are 129 million housing units in the United States, comprising owner-occupied, rented, and vacant units. Of these, 18.5 million are empty. This vacancy rate is 2.5 percentage points higher than it has been at any point in the half century the data have been tracked, translating into at least 3 million too many empty housing units in the country. This number, moreover, is rising. This is the most intractable part of the real estate bubble, for we cannot find a true bottom to home prices until this inventory of empty units starts to clear, and we cannot find a bottom to the mortgage finance market until home prices bottom out.

The worst type of inventory is an empty house, which people in the industry like to say has about the same half-life as a head of cabbage. As the former chairman of the Neighborhood Investment

Lawrence B. Lindsey is a visiting scholar at AEI. A version of this article appeared in *The Weekly Standard* on June 9, 2008.

Corporation, I have seen the damage done to neighborhoods by vacant homes. They are never maintained adequately, depress surrounding property values, and can quickly become temporary retail space for drug lords and a playground for juvenile delinquents. They are also the homes whose owners have the least incentive, and usually the least ability, to service the mortgage or pay the property taxes. So whittling down the inventory of empty houses should be the first economic, social, financial, and political objective.

The math of the housing market is fairly clear. Each year, roughly half a million homes are destroyed to make better use of the land on which they sit. Population growth also helps whittle down inventory. The household formation years—ages 25 to 34—have 39.5 million people in them forming 19 million households, a group that creates demand for 1.8 to 1.9 million units each year. On the other hand, households pass from the scene later in life, and the homes they used to live in go onto the market. There are 11.6 million households of 65- to 74-year-olds and 9 million households of 75- to 84-year-olds. Their departure increases supply by around 1.1 million units per year. On net, therefore, demographic realities add about 850,000 units to demand on top of the half-million homes that are destroyed and removed from supply.

The home building industry is in a deep recession, with additional yearly new home supply cut in half since 2006. But homebuilders are still adding nearly a million units per year. The math is simple: build a million, tear down half a million, form 850,000 households, and the country only whittles down its excess inventory by 350,000 units per year. This is one reason to expect a further drop in new home construction, but it will still take years to get our housing inventory back to normal. The economic, social, and financial damage over that time could be staggering.

Washington to the Rescue?

Faced with this situation, politicians are rushing to do something, anything, about the problem. One of the first efforts was to provide relief—$25 billion over the next two years—to the homebuilding industry in the form of "net loss carryback" tax provisions. (Note that if the real problem is a glut of vacant housing on the market, one of the least helpful things Congress could do would be to keep the homebuilders in business so they could increase supply still further.)

But most legislative activity merely ignores the vacant home problem rather than making it worse. Congressmen do not want to appear to be helping speculators, liars, or cheats. The trouble is, a good part of the problem was caused by people who might be considered speculators, liars, and cheats. Speculators by definition bought vacant properties in the hope of "flipping" them for a higher price. A vacant home is therefore a good sign of speculative activity. Moreover, some studies of foreclosed homes indicate that a majority of the foreclosures involved misrepresentations by the borrower. The most typical misrepresentation was that the borrower intended to live in the property; an owner-occupied property generally receives a lower interest rate than one that will be rented out.

> The worst type of inventory is an empty house, which people in the industry like to say has about the same half-life as a head of cabbage.

The case of Representative Laura Richardson (D-Calif.) illustrates a number of these problems. According to reporting by *Capitol Weekly* ("The Newspaper of California Government and Politics"), the *Wall Street Journal*'s online edition, and DailyBreeze.com, Richardson was delinquent on three personal home mortgages. Her Sacramento home was recently sold at auction, and as of May 23, foreclosure was pending on a home in San Pedro. A home in Long Beach went into default on March 28—no payment had been made since November—but Richardson "was able to bring her payments up to date." Her lender on the Sacramento mortgage, Washington Mutual, lost some $200,000, and the home's buyer agreed to pay the $9,000 in property taxes she had in arrears on the property. On the San Pedro house, she owed $367,436 on a $359,000 loan made in 2005 and had not made a payment since last June. The Long Beach home was the collateral for a $100,000 loan she in turn lent to her campaign for a state assembly seat in 2006, and though she raised enough to pay herself (and presumably the bank) back, she plowed that money into her 2007 race for Congress.

Richardson's situation—while unusual in that she changed jobs and cities three times in a short space of time—highlights a number of the problems Congress must wrestle with. She had three vacant homes, and

news reports of neighbor complaints suggest they were not being kept up and taxes were not being paid. Reportedly, one home loan was used for "consumption"—political campaigns—that involved no improvement in the value of the collateral, a bit like taking out a home equity loan for a trip to Vegas. The home values declined drastically—27 percent over 17 months in the case of the Sacramento home, whose ultimate buyer was a speculator. Until recently, congressional action and most press coverage of the housing market have adopted the premise that innocent home buyers are struggling to meet payments so as to stay in the family home. But on a scale of one to ten, where one represents a person victimized by an unscrupulous lender and ten is the delinquent owner of three vacant homes, most people defaulting on a mortgage fall in the range of five to eight.

> If Congress is unlikely to "solve" the problem any time soon, that leaves the market, and it must deal with three simultaneous and interrelated excesses: homebuilders made too many houses, prices rose too high, and credit standards dropped too low. Each is unraveling at its own pace.

The best-thought-out bill in Washington is sponsored by Barney Frank (D-Mass.), chairman of the House Financial Services Committee. He is intellectually honest and one of the few chairmen who puts his bills out in the light of day for people to evaluate before he jams them through. Under Frank's proposal, participating mortgage holders would have to write down the value of their loans to 10 percent below current market value and pay a 5 percent fee. With home prices already off 20 percent in troubled areas, this would mean writing off a third of the original mortgage, assuming the 94 percent loan-to-value ratio typical for first-time home buyers in 2006. In return, the homeowner would receive a government-backed FHA loan—ideally at a low enough rate that they could afford to stay in the home. And, of course, vacant homes would not qualify.

Lenders and borrowers willing to take the Frank option would have to fit in a fairly thin slice of the market in which home prices have already stabilized so borrowers do not expect to go underwater again but have not declined so much as to have already wiped out most of the value of the mortgage. Note that the bill would require a reappraisal in the midst of a plummeting housing market. The nonpartisan Congressional Budget Office estimates that this plan would help five hundred thousand people over four years. But by the time the plan took effect, we would likely have had an additional 2 million foreclosures beyond what would be expected in normal times. The most valid criticism of the Frank plan is that by itself it would not put a bottom in the housing market. Frank admits as much, saying he wants to slow the pace at which home prices are falling, not impede the adjustment.

But politics being what it is, opponents of the Frank bill have cried "bailout." His plan is estimated to cost $1.7 billion, which in Washington is a rounding error as "bailouts" go. Consider for example the Senate's overwhelming support for a $25 billion bailout for homebuilders or the fact that a majority of House Republicans joined with Democrats to override President Bush's veto of the most pork-laden farm bill in history, as did all but fourteen Republican senators. That legislation contained such high national priorities as $170 million for accelerated depreciation of race horses, the pro rata equivalent of stopping fifty thousand foreclosures under the Frank plan. Frank's bill is narrowly targeted to avoid the political and moral problems involved in bailing out the undeserving. It is hardly a bailout. But that is also what makes it far from a panacea for the housing problem.

Back to the Market

If Congress is therefore unlikely to "solve" the problem any time soon, that leaves the market, and it must deal with three simultaneous and interrelated excesses: homebuilders made too many houses, prices rose too high, and credit standards dropped too low. Each is unraveling at its own pace. As noted, homebuilders have cut new construction in half, but that is still probably not enough. The credit markets reacted fastest and with devastating effect. The Federal Reserve had to take a series of extraordinary measures to keep the financial system afloat during the credit tightening. A full 40 percent of the mortgage market has disappeared since August, and most of this will not come back in the new era of higher down payments and real credit scoring.

Markets correct huge inventory overhangs and declines in demand due to the scarcity of credit by lowering prices. Home prices are correcting, though more

slowly than the credit market shrank. Prices are down over 14 percent in aggregate since their peak in 2006—having adjusted in a year and a half as much as liquid markets might in a month. The pace of decline, about a 30 percent annual rate in recent months, is still accelerating. The California Association of Realtors reports that the median price fell that much in just the last year. Futures markets are predicting that home prices will fall over 30 percent in aggregate on a national basis, with 70 percent of the drop happening by year's end. I personally think the decline will be less, but just as 2007 was the year that mortgage credit dried up, 2008 will be the year that home prices plummet.

During the last real estate collapse in the early 1990s, the government was forced to acquire a large amount of property as it worked to rescue the financial system. The chances are reasonable that at some point late in 2009 a similar approach might be adopted.

Just a 20 percent decline in home prices would place a quarter of mortgages under water, and a 30 percent decline still more. The great uncertainty is how homeowners will respond: do they walk away from an asset that is worth less than what they owe on it? The foreclosure prevention activity by Congress and a somewhat different approach proposed by Harvard's Martin Feldstein are designed to keep as many people in their homes as possible, despite the lower prices.

But prices must still decline to clear the excess inventory. Private sector players must be induced to hold more housing than they currently do, and that can only happen at lower prices. This can take the form of more second home purchases or investment in rental property. The latter only makes sense if the price is lower because with more units around, the property is likely to be vacant more of the time. Finally, price declines can convince speculators—those politically dreaded beings—into buying houses in the expectation that prices will recover in the future. Recall that a 27 percent price decline induced one such speculator to buy Representative Richardson's foreclosed Sacramento home.

The problem with this is that the wealth loss to the household sector and to the financial services industry would be huge. A 30 percent drop in prices would shrink household assets by about $6.5 trillion. Under normal economic rules of thumb, that would permanently lower household spending by $200–300 billion, or between 1.5 and 2 percent of GDP—not enough for a recession by itself, but the collateral damage to the financial system would likely be sufficient to induce a downturn similar to those in the 1970s and early 1980s.

More Exotic Buyers

Optimists hope that new types of buyers will emerge, with three types leading the pack: foreigners, inflation hedgers, and the government itself. Some have said that laxer immigration laws are the way to absorb excess houses under the theory that immigrants need homes. In its popular version, this view is actually quite naive. It is harder to imagine an easier immigration situation than the one that existed in the past few years, with its negligible enforcement. But what one might call "volume" immigrants are not the answer. They are here to make money and save it and crowd themselves into housing, making them poor absorbers of excess homes. Moreover, many of them worked in the home construction, remodeling, and maintenance industries and are now unemployed and leaving the country. Opening the borders further to this type of immigrant is not only politically problematic, but also runs counter to current economic reality.

By contrast, "targeted" immigration might just do the trick. Imagine a hypothetical immigration program that gave a provisional green card to anyone who invested at least $10 million in residential property and held it five years. To stop them from buying just their own expensive Upper East Side apartments, one might cap the value in each property toward the quota at $1 million. A mere one hundred thousand people signing up would not only pump a minimum of $1 trillion into the housing industry, they would also absorb at least one-third of the current excess inventory. Trouble is, such high-end immigration is just the type that a Democratic Congress finds most objectionable ideologically.

But foreigners might also be part of the solution thanks to the falling dollar. Not only are house prices likely to be down significantly from their peak, but so is the dollar. The cumulative decline in, say, condominiums in Florida or Las Vegas is at least 50 percent to a European, Japanese, or British buyer. So even without legislation to encourage them, foreigners are likely to provide some of the solution to the housing overhang.

Inflation hedgers are another potential source of demand. They are speculators who are willing to bet that borrowing at low, fixed, long-term interest rates on real property that will in the long run grow with inflation may be a good investment. True, Federal Reserve governors are correctly expressing their concern about gathering signs of inflation. But it is certainly not out of the question that the political, economic, and banking system pressures might induce the Fed to follow a more inflationary path. The Fed's first job is to preserve the banking system, and a 30 percent national home price decline would certainly prompt it to take action. This would cost money, which the Fed can create, albeit with a risk of further inflation. Now is probably not the moment to place that bet, but if home prices continue to decline at their current rate, late this year or early next year might be.

Finally, there is the government itself. During the last real estate collapse in the early 1990s, the government was forced to acquire a large amount of property as it worked to rescue the financial system. The chances are reasonable that at some point late in 2009 a similar approach might be adopted. The last time around it was called the Resolution Trust Corporation (RTC). It was, as one would expect from government, far from surgical in its approach. A lot of investors, bankers, and property holders probably lost more than they deserved to in the process. But it got the job done. It is the ultimate last resort, using the balance sheet of Uncle Sam to save the housing market. If nothing else works, a new RTC is in the cards, and those who think Barney Frank's bill is a "bailout" will be shocked by its size.

The housing market crash is far from over, and its ramifications will be with us for some time. The combination of excessively easy credit, a rapid run up in prices, and overbuilding set the stage for the current mess. Prices must fall to correct oversupply, and that, in turn, will further adversely affect both consumer confidence and financial solvency. The unique nature of the problem makes a precise ending hard to predict. But it seems likely that some combination of speculative buying, inflation, and purchases by both foreigners and government entities will correct the situation. Now is not the time for ideology, of either the left-wing variety (soak the rich, punish speculators, and conduct a witch hunt through the financial community) or the right-wing variety (stave off government involvement of any form). Pragmatism is a conservative virtue. It is time for everyone to start practicing it.