

The U.S. Housing Market Blues

By Desmond Lachman
Gazeta Mercantil (Brazil)
December 4, 2007

The chickens have finally come home to roost on the U.S. housing market. As U.S. housing prices have now started to decline at an accelerating rate, there can be no doubt that the U.S. is presently in the throes of its worst housing bust in the past sixty years. And as estimates of subprime mortgage related losses in the financial system mount, there is every indication that the housing market woes will spread to the rest of the U.S. economy.

In attempting to gauge how serious the ongoing U.S. housing bust might be it is well to reflect on from where we are coming. For between 2000 and 2006, the U.S. experienced an unprecedented housing price bubble, with real home prices increasing by a staggering 80 percent. As a result, the ratio of home prices to incomes surged from an historic average of 3.2 to its present level of 4.5, which would support the view that home prices could fall by anywhere between 20 and 30 percent in the course of the current downturn.

U.S. home prices are already declining at the national level to a degree that has not been experienced since the Great Depression. Yet the inventory of unsold homes has risen to record levels, while a whole host of factors are conspiring to severely constrain housing demand in the year ahead. Mortgage lending standards are being substantially tightened, Adjustable Rate Mortgages are due to reset in increased amounts, and speculative positions are being unwound. Little wonder then that the futures market in the Shiller-Case housing market index is suggesting that home prices in most major U.S. cities will fall by between 5 percent and 10 percent a year over the next two years.

Among the more disturbing factors weighing on the U.S. housing market is the prospective heavy resetting of Adjustable Rate Mortgages. Over the next eighteen months, an estimated US\$800 billion in ARMs are scheduled to reset. And they will do so at interest rates that are very much higher than the two-to-three year "teaser" rates at which those long-dated mortgages were contracted.

More disturbing still is the fact that the quality of the ARMs that are due to reset in 2008 is materially worse than those that are presently resetting. This will almost certainly compound the loan losses of the U.S. banking system and will also result in a spike in the number of foreclosures next year. Official estimates are suggesting that there could be as many as an additional 2 million home foreclosures next year, which will add supply to an already saturated housing market.

The optimists on Wall Street never seem to tire of minimizing the collateral damage of the present housing market bust by pointing out that residential construction constitutes only 5 percent of the U.S. economy. In so doing, they turn a blind eye to the significantly negative impact that reduced housing market wealth will have on the American consumer, who accounts for around 70 percent of overall demand. In recent Congressional testimony, Ben Bernanke has

suggested that for every \$1 decline in housing market wealth, consumer spending could eventually be constrained by between 4 to 9 cents.

More importantly, the optimists choose to totally overlook the material damage that the housing market bust is presently wreaking on the U.S. financial system. Estimates of the likely eventual sub-prime related losses in the U.S. financial system have now escalated to between US\$200 billion and US\$400 billion. This must mean that further big loan loss write-offs lie ahead since to date the banks have only recognized around US\$50 billion of those losses.

It is often argued that, while large in absolute terms, the potential sub-prime losses are not large relative to the size of the banking systems overall balance sheet or to its capital base. However, that line of reasoning overlooks the fact that having to recognize large loan losses, the banks have now become very much less willing to take on new risk and are in the process of severely cutting back on lending. It also ignores the fact that the acute lack of transparency in bank lending makes it virtually impossible to know where those loan losses reside, which makes banks highly fearful of lending to one another.

Over the past few years, the Federal Reserve has hardly covered itself in glory, as it did nothing to prevent the housing bubble from developing. Nor did it distinguish itself this year by being so slow to anticipate the serious ramifications for the financial system of the bursting of that bubble. One can only hope that, in the months ahead, the Fed does not make the mistake of underestimating the likely negative effect of the bursting of that bubble and that it cuts interest rates aggressively to cushion the economy from the fallout of the ongoing U.S. housing market debacle.

Desmond Lachman is a resident fellow at AEI.