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The Recession and the Housing Drag

The more the government tries to prevent prices from finding an equilibrium, the longer it will take for the economy to begin growing again.

By MORTIMER ZUCKERMAN

A decent house has long been a symbol of middle-class American family life. Practically, it has been a secure shelter for the children and provided access to a good public education. And financially, it has been regarded as a safe store of value, a shield against the vagaries of the economy and a long-term retirement asset.

All that seems a distant memory for the millions of American families who must confront the decline in the value of their homes. The pressure to meet mortgage payments on properties that have lost value has been especially shocking for those who have lost their jobs in the Great Recession. Their houses have become a ball and chain, restricting their ability to seek employment elsewhere. They cannot afford to abandon the remaining equity they have in their houses—and they can't sell in this miserable market.

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Martin Kozlowski

New home sales, pending home sales, and mortgage applications are down to a 13-year low, despite long-term mortgage rates that plummeted recently to an average 4.3% before rising slightly. New home prices have fallen by an average of 30%. According to David Rosenberg, chief economist at Gluskin Sheff, this has reduced home occupancy cost to 15% of family incomes, down from the conventional 25%.

The fall in house prices has eaten away at the equity Americans have in their homes. About 11 million residential properties have mortgage balances that exceed the home's value, notes Mr. Rosenberg. And given the total inventory of homes and the shadow inventory of 3.7 million empty (foreclosed) homes, he notes that prices might fall another 5% to 10%. That would leave an estimated 40% of American homeowners with mortgages in excess of the value of their homes.

Disappearing equity invites strategic defaults. Homeowners with negative equity are tempted simply to mail in their keys to their friendly lender even if they can afford the mortgage payment. Yet banks don't want to take the deflated properties onto their books because they will then have to declare a financial loss and still have to worry about maintaining the properties. Little wonder, according to Mr. Rosenberg, that foreclosure has not been enforced on a quarter of the people who haven't made a single mortgage payment in the last two years.

A staggering eight million home loans are in some state of delinquency, default or foreclosure, Alan Abelson reported in Barron's in July. He noted that another eight million homeowners are estimated to have mortgages representing 95% or more of the value of their homes, leaving them with 5% or less equity in their homes and thus vulnerable to further price declines.

The pace of foreclosures slowed briefly thanks to loan modifications by the Home Affordable Modification Program and other government efforts. But the programs have not been working as hoped—it's been reported that half of the borrowers have been redefaulting within 12 months, even after monthly payments were cut by as much as 50%.

While the foreclosure pipeline remains clogged, as it unclogs a new wave of homes will wash into the market and precipitate additional downward pressure on prices. The number of foreclosed homes put on the market by banks will be a more powerful influence on the further decline of home prices than either consumer demand or interest rates.

A well-balanced housing market has a supply of about five to six months. These days the inventory backlog has surged to about a 12½ months' supply. This explains why average sale prices have been declining for so many months. The high end of the market, in particular, is under great pressure.

The mortgage market is also deeply troubled. Conventional lenders now insist on a substantial down payment and impose other more stringent financial requirements. Household formation (marriages) is also shrinking now, down to an annual rate of about 600,000, compared to net household formation in excess of a million annually during the bubble years.

The most critical factor subduing the demand for housing is that home ownership is no longer seen as the great, long-term buildup in equity value. So it is not too difficult to understand why demand for housing has declined and will not revive anytime soon.

This is a disturbing development for those who believe that housing is going to lead America to an economic recovery, as it did during the Great Depression and every recession since. In the past, residential construction preceded the recovery in the larger economy. This time a lead weight on recovery has been the disappearance of some $6 trillion of home equity value, a loss that has had a devastating effect on consumer confidence, retirement savings and current spending.

Every further 1% decline in home prices today lowers household wealth by approximately $170 billion, according to Goldman Sachs. For each dollar lost in housing wealth, Goldman Sachs estimates that consumption is lowered by 5 cents. Add to this the fact that we are building a million-plus fewer homes on an annual basis from the peak years of the housing boom. With five people or more working on each home, we have permanently lost over five million jobs in residential construction.

That is why housing was such an important generator of normal economic recoveries. To give this context, residential construction was 6.3% of GDP at its recent peak in 2005 and 2006 but has fallen to 2.4% this year, according to economist A. Gary Shilling. This is significant if you recognize that a 3% top-to-bottom decline in real GDP constitutes a serious recession.

There is no painless, quick fix for this catastrophe. The more the government tries to paper over the housing crisis and prevent housing from seeking its own equilibrium value in real terms, the longer it will take to find out what is true market pricing and then be able to grow from there.

Mr. Zuckerman is chairman and editor in chief of U.S. News & World Report.

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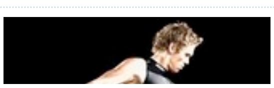

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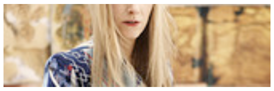

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