The Affordable Mortgage Depression

Government policies were designed to increase homeownership. Affordable Mortgages, created to realize this goal, were responsible for the Housing Bubble and distorted the economy. The unwinding of these distortions will result in a Global Depression.

Analyzing Economic Distortions That Caused the Housing Bubble and Will Produce a Prolonged Depression

Section 1 of the 10-part Affordable Mortgage Depression Manifesto

The following represents perceptions of the Housing Bubble and expectations for a Depression which were developed during 2005-2006 and have evolved with the financial crisis. It is the author's opinion that this analysis reflects an accurate understanding of the underlying economic forces which created the current financial downturn and will continue to affect the economy through at minimum 2012. It is through an understanding of these forces that policy makers can craft suitable responses to the crisis, in defiance of political expediency, and act to ensure that similar self-inflicted injuries are not recreated.

An Inability to Recognize the Problems Created by the Housing Bubble

For the last three years economists, politicians and policy makers have been consistently surprised by declining housing values and resulting collateral damage to the economy.

As recently as 2005 these prognosticators perceived residential real estate to be a safe asset class that would not decline nationally. As problems within the housing market emerged and foreclosures began increasing, policy makers stated emphatically that disruptions would be restricted to subprime mortgages. The credit market dislocation of August 2007 was interpreted by these parties as a one-time and temporary event. Further disruptions to the global financial markets accompanying the Bear Stearns collapse, were supposedly averted by a government bailout. Politicians overtly used Fannie Mae and Freddie Mac in a misguided attempt to prop up the faltering housing market despite dangerous leverage and declining fundamentals. Government sponsored interest rate cuts, stimulus checks, liquidity injections and bailouts have been implemented with the intent to solve economic problems as they emerged and deepened.

In short, politicians and government policy enthusiasts have consistently failed to predict, correctly interpret or fully understand our evolving economic crisis. Oblivious to their lack of understanding, calls for further intervention, stimulus, bailouts and price manipulation continue to proliferate. Most of these efforts are unwise, unlikely to result in positive outcomes and have the potential to exacerbate current economic distress.

The Real Problem

Irrespective of government efforts to fight a growing laundry list of financial calamities, the real challenge facing our economy is that houses remain dramatically overpriced relative to the fundamentals that determine value. Unsustainable housing values are rarely credited as the source of recent economic volatility. More dramatic events including the collapse of the dollar, falling real estate prices, rising foreclosures, increased inflation, record oil prices, company failures, credit market disruptions, rising unemployment and the stock market collapse have tended to dominate the economic consciousness of the media and attracted the focus of policy makers.

These gyrations, although dramatic and painful, are not independent events nor or they the cause of our economic decent. Such events are the manifest symptoms of the fundamental problem of overvalued housing. The only realistic solution is for home prices to fall until they reach a sustainable equilibrium.

There is nothing inherently wrong with falling housing values. In fact, a lot of good comes from such asset price declines. Young people, individuals of limited means, those who have demonstrated fiscal responsibility, savers and future generations of potential homeowners all benefit from dropping housing prices. It is an interesting phenomenon that so little attention was paid to this group directly harmed by rising home prices and that a similar lack of interest is directed towards their benefit as prices fall.

The economic pain presently being experienced is the result of excessive debt that was attached to homes as prices rose nationally for a decade. These excessive debt levels were used as a means by which to purchase increasingly expensive housing, monetize paper equity gains and to leverage investment returns as property values rose steadily. Now that property values are falling, the leverage is having a sharply negative impact on the economy. Debt remains while the value of recently purchased houses has fallen and theoretical equity gains have evaporated. Leverage is especially painful when asset values decline as equity is destroyed at a rate that is magnified by the ratio of debt. This phenomenon is prevalent in an environment where little or no capital was necessary to buy houses in recent years. An increasingly large percentage of home owners now owe more money on their mortgages than the value of the underlying property. The level of homeowner equity relative to mortgage debt in the United States is at a record low and falling.

The decade of rising prices also materially distorted economic activity. Homeownership rates ranged between 65% and 70% during the boom. There has never been an asset class, much less an asset bubble, which directly impacted such a high percentage or large number of Americans. The direct and indirect wealth effects derived from rapidly rising equity values had a dramatic impact on the economy due to this high rate of ownership. Consumer spending and the national savings rate were dramatically distorted. Now that housing prices have stopped rising, the economy has been deprived of this sizeable, recurring and growing source of consumer spending.

The incremental consumption from rising home values, home equity loans and windfall gains on house sales is gone while the debt attributed to overvalued housing prices remains, must be serviced and repaid. The implications for consumer spending, unemployment and the economy are unavoidable.

Declining home prices impact the majority of our economy. Recent economic events are the painful symptoms of the resolution of this overvaluation problem. The more quickly prices can return to fundamentally sustainable levels the better. Regrettably, the slow moving housing market, compounded by the extraordinary amount of leverage which we have attached to overvalued houses, will inflict unavoidable economic pain that is unlikely to subside for years.

Government efforts have been directed at muting the impact of these symptoms. Some proposals have even attempted to prop up the falling house prices. A closer analysis and better understanding of the forces which created the Housing Bubble illustrates why such intervention can not work. If government intervention has the effect, either intentionally or unintentionally, of artificially propping up housing prices, such action will cause the economic impact of the inevitable correction to be more damaging.

Link to Section 2 of The Affordable Mortgage Depression Manifesto: "The Real Estate Bubble"

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Posted by Whitney Ross at 11/3/2008 12:45 PM
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Comments

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Photoman2010 wrote: *11/5/2008 6:50 PM*

I could not agree with you more. I am a person who has been very responsible with my money all the while saving to purchase a house. I firmly believe that it is only a short matter of time before current homeowners that have to sell their houses realize that they are going to be closing on the sale of their home for much less then they wanted do to unrealistic value expectations. Cash is "KING" and me and my cash will continue to wait it out.

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