How to shore up America's crumbling housing market

By Martin Feldstein
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The risk of a downward spiral of house prices is the primary danger facing the American economy. Because of the structure of securitised mortgage finance, this risk has the potential to cause a global financial crisis. Both of these problems will remain until a new policy brings stability to house prices.

The current decline of house prices is the natural result of the bubble that by 2006 had raised house prices to 60 per cent above their long-term trend. The sharp decline since then means that today's prices are about 15 per cent above the trend level. But while a further 15 per cent decline may be inevitable, there is nothing to stop prices declining even further.

House prices that could overshoot by 60 per cent on the way up could also overshoot substantially on the way down. During the past 12 months, house prices across the nation fell by an average of 16 per cent. The large overhang of unsold homes continues to create pressure for further price declines. The record level of defaults and foreclosures continues to add to the stock of unsold homes. Potential house buyers who foresee continued foreclosures are reluctant to buy now because they anticipate future price declines.

A policy is needed that will permit the appropriate 15 per cent additional decline in house prices but end the risk of a further downward spiral. No such policy is now in place or on the legislative drawing board. The fear of continued mortgage

defaults and house price declines is depressing the prices of mortgage-backed securities and of the derivative products based on them. This fall, in turn, is causing large losses at commercial banks and other financial institutions.

Because of the uncertain values of mortgage-backed securities, financial institutions lack confidence in the liquidity and solvency of counterparties and even in the value of their own capital. Without that confidence, there cannot be adequate credit flows and without credit there cannot be economic activity and growth.

Mortgage-backed securities cannot be valued with any confidence until there is more certainty about the future of house prices. The precariousness of the situation reflects the very high ratio of individual mortgage balances to the underlying current house values. Because of the decline in house prices that has already occurred, more than 10m home owners now have mortgages that exceed the values of their house. This is 20 per cent of all homeowners with mortgages. For half of that negative equity group, the debt exceeds the house value by more than 20 per cent. If house prices fall another 15 per cent, negative equity mortgages will rise to 20m.

Negative equity mortgages are a big source of instability because US home mortgages are generally "no recourse" loans, implying that if an individual defaults on his mortgage the creditor can take the property but cannot claim other assets or income to pay the remaining loan balance.

The large and growing number of homeowners with negative equity will increase the rate of defaults and foreclosures and therefore drive the downward spiral of prices. Defaults are likely to accelerate as the ratio of the debt to the home value rises. While a homeowner who owes 10 per cent more than the value of a house may continue to service the mortgage, when the excess debt reaches 30 per cent he is much more likely to default. Each such default puts downward pressure on existing prices, increasing the likelihood of further defaults. It is this spiral that threatens the American economy and the global financial system.

The policies adopted until now will not stop the downward price spiral. Although the Federal Reserve has reduced the overnight interest rate from 5.25 per cent a year ago to 2 per cent now, mortgage interest rates are now higher than they were a year ago. The Treasury's programme to encourage voluntary mortgage renegotiations has had little effect, because most mortgages have been securitised and are no longer held by the originating institution. The recently enacted housing legislation is expected to help 400,000 negative equity homeowners, less than 5 per cent of the 10m who have negative equity, and does nothing to stop the defaults among the millions more who will be pushed into negative equity if prices continue to fall.

This is a difficult problem and there are no easy solutions. I have proposed a programme of "mortgage replacement loans" that I believe would stop the downward spiral of house prices. The basic idea is to provide an incentive to stop defaults among those who now have positive equity but are vulnerable to a further price decline. The federal government would offer every homeowner with a mortgage the opportunity to replace 20 per cent of that mortgage with a low interest government loan – up to a loan limit of $80,000 (€55,000, £44,000) – that reflects the government's lower borrowing rate. Creditors would be required to accept this partial mortgage pay-down and to reduce the monthly interest and principal by the same 20 per cent. That mortgage replacement loan would not be collateralised by the house but would be a loan that the government could enforce by lodging a claim on an individual who does not pay.

With the mortgage replacement loan, people who now have a mortgage equal to 90 per cent of their house value would see that mortgage fall to just 72 per cent of the house value, implying that it would take a very unlikely price fall of more than 28 per cent to push those individuals into negative equity.

By stopping the downward overshooting of house prices, the mortgage replacement programme would help all homeowners, including those who now have negative equity. Limiting the destruction of homeowners' wealth would help to maintain consumer spending, boosting production and employment. Renters as well as homeowners would benefit. And stabilising the values of mortgage-backed securities would strengthen financial institutions, increasing credit flows that would further stimulate the economy.

There may be better ideas for stopping the downward spiral of house prices, but I have not heard them. The proposal to rewrite the bankruptcy law to allow individuals to persuade a judge to let them keep their homes while declaring bankruptcy would abrogate existing contracts. By making mortgages less secure, it would also raise mortgage rates for future borrowers. The proposal to revive the Great Depression-era programme of government mortgage lending would burden taxpayers and involve delays while millions of homes are appraised. Neither idea is appealing.

The US economy is sliding into recession. Employment, industrial production and real incomes are declining. Monetary policy has little traction because of the dysfunctional credit markets and the collapse of housing. The fiscal policy of tax rebates failed to achieve a significant impact on consumer spending. The economy will continue to decline and the financial markets to deteriorate unless a policy is adopted to stop the downward spiral of house prices.

The writer is professor of economics at Harvard University