

No Quick Fix for the Housing Market

BY JOHN A. WEINBERG

In most U.S. business cycles of the last 60 years, housing has led the way. Typically, residential investment falls before the peak in broader economic activity, and begins to rebound — usually quite sharply — before the trough. In this cycle, the pattern held up near the top of the cycle — residential investment peaked in late 2005 while the business cycle peak was in the fourth quarter of 2007. But at the bottom, things have been quite different this time around. The recession ended in the middle of 2009, but residential investment continued to decline through most of 2010 and has shown very little growth since then. Other indicators of housing activity — home sales and prices — have continued to indicate a depressed residential sector.

This historically atypical behavior of housing has led some to conclude that a more robust recovery of housing markets is a necessary precondition for a robust economic recovery more broadly. And the economic recovery has indeed been disappointing for going on three years now. But from a strictly arithmetic point of view, the slow recovery in housing doesn't seem to be able to explain the performance of the broader economy. In other words, there are other factors at play that also are keeping the economy from growing more rapidly.

Of course, the performance of the housing market affects consumer spending. During the housing boom, many people used their growing housing wealth — tapped through home equity lines of credit, for instance — to finance spending on an array of goods and services. The subsequent bust in home prices not only deprived households of this source of consumption growth, but also placed many in a financial hole, owing more on their houses than they are worth at current prices. Indeed, there is evidence that consumption has been particularly weak in areas that experienced large house price declines and where homeowners were particularly leveraged.

The financial distress brought on by falling home prices also means that the number of houses at some stage of the foreclosure process or already owned by the bank has reached very high levels. This has placed stress on the ability of financial institutions and the legal system to deal with the flow of troubled mortgages. It has also resulted in a large and growing inventory of foreclosed properties available for sale, many of them vacant.

This inventory of houses — both those that are in various stages of the foreclosure process and those that are bank owned — has made it difficult for markets to clear quickly. Houses for sale remain for sale longer, and prices adjust more slowly. With this process moving slowly, people in many local

markets remain uncertain of whether prices have reached their bottom. Uncertainty, in turn, adds to the slow pace with which markets adjust.

Given the considerable challenges still facing the home market, and given housing's traditional role as a leading sector in economic recoveries, many have sought ways for public policy to speed up the market's adjustment process — for instance, through additional loan modification programs that enable some distressed borrowers to restructure their debts and keep their houses out of foreclosure. While such proposals certainly merit consideration, the success of

similar initiatives so far has been mixed. Moreover, even if carefully crafted new measures could hasten the ultimate resolution of the housing market's current slump, there really is no quick fix for the most

fundamental problem facing that market — the fact that home building simply got ahead of demand during the boom of the early 2000s. This left an inventory overhang of houses that were built but never sold, and which exists independently of the financial conditions of borrowers and lenders. To a considerable extent, working down that inventory will simply take some time.

Policies that can assist distressed households could ease the constraints some feel on their broader consumption expenditures. But it is worth remembering that most such policies amount to a transfer from others in the private sector — which could dampen the impact on overall private spending. And just as house prices ran up over a relatively long period of time prior to this recession, it seems clear there will continue to be a considerable period of adjustment until the market fully stabilizes. Similarly, just as we should have been cautious about some public policies that likely contributed to the boom and subsequent bust — for instance, the coordinated efforts of multiple agencies to promote homeownership as a near-universal goal — we also should be cautious now about proposals that may show promise in the short run but also could contribute to long-run distortions.

Troubles in the housing market have drawn the attention of well-intentioned people with a variety of perspectives. Understandably, the temptation for policymakers to intervene is great, but such problems may present no easy solution, meaning a policy of hands off may ultimately be the one that is most effective in getting people back on their feet.

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