

Housing And The Current US Recession.

At the heart of the credit crisis in 2007/2008 was the US housing market. The almost one way growth of housing prices led many to discount the possibility of declining prices. Rising prices fed consumption in the form of home equity loans and home equity lines of credit. It also drove consumers to spend not only out of income but also out of capital, namely, home equity.

The response to the subsequent bursting of the credit and real estate bubble had been first to deal with liquidity and then with solvency but always at the mortgage level. Since then there has been a wholesale transfer of distressed assets from private balance sheets to the government's balance sheet, a move that has boosted equity and high yield markets, commodities and gold even as it stressed sovereign balance sheets.

It is therefore surprising that more attention has not been paid to the housing market. The main topical concerns today are inflation, European sovereign debt, US employment, energy and in particular oil prices, instability in the MENA region... All valid concerns, but what about house prices? The Case Shiller index has slipped into negative territory since Sep 2010 and currently is declining at 3.33% annualized, in what is clearly a double dip. Mortgage delinquencies have stopped rising but remain persistently high. In the Alt A and non-Conforming mortgages delinquencies continue to rise. Housing starts have begun to decline in earnest again, which is probably not a bad thing.

Housing is the one of the largest portions of a household's wealth. As long as housing fails to recover household wealth is impaired and the ability to borrow and spend is impaired.

This argument requires that one agree with Case, Shiller, Quigley (2005) and not with the refutation by Calomiris, Longhofer, Miles (2006) about the housing wealth effect. However, even if one disagrees with Case, Shiller, Quigley, it is undeniable that the value of one's house is one of the largest sources of acceptable collateral a household may post for credit.

In order for a sustained recovery, house prices need to stabilize and recover. How can the government help?

Interest rates need to remain low. At these low levels of interest rates, the smallest rate hike translates into a sizeable increase in monthly mortgage payments. The Fed may be forced into raising rates if inflation starts to pick up, but given the large weight given to housing with the CPI, it's likely that the Fed will be given sufficient room to keep interest rates lower for longer without official CPI numbers picking up too much. Quantitative easing and central bank MBS purchases also aid the cause as they keep longer term financing rates and spreads low and affordable.

Employment needs to pick up. Mortgages are paid out of wages, not thin air, and not from temporary work. Employment, however, is a function of general GDP growth which is dependent on consumption which is in turn dependent on the stock as well as rate of change of wealth. Relying on employment is a circular argument.

The government may assume the role of land owner of last resort and stand to hold foreclosed collateral and purchase real estate inventory for lease back to the public at affordable rates. This may be politically unworkable but it will underwrite the value of real estate. It would also be as difficult to finance as the purchase of financial assets like MBS and USTs.

Quantitative easing debases fiat currency relative to hard

assets but the real estate overhang is sufficient that QE policy has proven to be a blunt instrument inflating the value of everything else but real estate. As a blunt instrument it inflates aggregate nominal output. It is not even able to guarantee that it will inflate the nominal output in each asset or good market or in a particular one. And even where it inflates nominal output in a given market, it is not able to distinguish between price inflation and real output growth. Whereas for economic growth it is hoped that real output growth would take place without excessive price inflation, the housing market was one in which it was hoped that policy would effect price inflation without real output growth. As it turned, the overhang in unsold homes has proven overwhelming so that housing starts are moribund, secondary home sales are weak and at the same time house prices continue to fall. It is perhaps indicative of the scale of the irrational exuberance, that drove house prices in the years prior to 2007 that the efforts of the Fed and Treasury to at the very least support nominal output growth in housing have been futile.

The lesson learnt here is that much of the consumption in the US in the run up to 2007 was financed by rising house prices and the availability of cheap credit. These rising house prices turned out to be illusory and not realizable. Therefore the consumption that it supported was transitory, the debt that for which it served as collateral is more than it can now or for the foreseeable future support, and the task at hand of creating rising housing prices is either ill-advised or will be futile.

It is time for non-conventional market operations in the physical real estate market.

The equally unthinkable alternative, which of course everyone says is impossible, is that the US is actually capable of making stuff that Emerging Markets need. Its easy to think of Caterpillar, Apple, Google, even Tiffany's, Coach, Ralph Lauren, Estee Lauder, or Phillips-van Heusen, but what of low

tech manufacturing? Impossible? Desperation is the grandmother of invention.