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Solving America's Housing Crisis

By Mark G. Dotzour

America's housing market problem is fairly simple to understand. Somewhere between one and two million vacant homes need tenants.

In some American communities, vacant homes are not being cared for, deteriorating the quality of the surrounding neighborhoods. This causes further price declines, which lead to more foreclosures. The fact is supply is running far ahead of demand.

What has to happen for the national housing market to stop falling? We need to decrease supply and increase demand. This can be done in four stages.

First, we must curtail the supply of new homes in the market. Virtually everyone agrees that falling home prices are at the center of the current economic and financial crisis in our country. Why are new homes still being built in cities where prices are collapsing and foreclosures are skyrocketing? Even in places like Detroit and Sacramento where foreclosures are at the highest levels, thousands of new homes are under construction.

In the first nine months of 2008, 2,825 new home building permits were issued in Sacramento and 1,528 in Detroit. When new homes are built in challenged markets and sold with massive price concessions, prices for all homes in those communities trend downward.

Second, we have to decrease the number of homes coming back into the market through foreclosures. Government efforts to do this have not worked so far. It appears the FDIC plan used to mitigate losses at IndyMac Bank offers a workable solution. FDIC Chair Sheila Bair is emerging as the new thought leader in this arena.

Simply helping people stay in their homes has disturbing

repercussions. If you are a homeowner 90 days delinquent on your mortgage and the government reduces the principal amount of your mortgage and lowers your mortgage payments significantly, what incentive do you have to get back on track? Only the stigma of bankruptcy and foreclosure will limit that trend.

If one homeowner in your neighborhood gets lower principal and lower payments, won't the other five owners on your block want the same thing? And the fact that the government is willing to consider "freezing interest rates on mortgages" and "cramming down principal" is not going unnoticed by bond investors.

Suppose you invested your grandmother's savings in mortgages that were expected to pay her 2 percent for two years and then 6 percent for the next eight years. One day you read in the newspaper that Congress is considering freezing the interest rate at 2 percent. Then you note that the chairman of the Federal Reserve is encouraging banks to write down principal balances on mortgages. Now grandma will be lucky to get 2 percent for the life of her bond and then $700 in principal back. Will you and grandma want to buy any more of these bonds?

Third, we have to increase demand for houses, and we have to do it quickly. How can the government do that?

Simple. It needs to give investors an incentive to purchase vacant homes and rent them to tenants. With solid mortgage underwriting standards, investors can buy these homes. There must be adequate down payment so the investor has a big incentive to keep the house. Additional incentives could be created by lowering the depreciation schedule to five to seven years for investors who buy foreclosed houses. To solve the problem extremely quickly, the federal government could offer these investors zero percent capital gains tax if they hold the properties for more than five years.

Tax policy frequently has been used by the federal government to modify behavior in America. A similar tax incentive was given to all businesses after Y2K to buy computers and software because of an acute lack of demand.

Getting vacant homes into the hands of private American citizen-owners will give people an incentive to keep the lawns mowed and windows from being boarded up. This will help staunch the decrease in neighborhood values resulting from lack of upkeep.

Fourth, mortgage rates are way too high. Over the past ten years, the 30-year mortgage rate has been priced somewhere around 1.5 percent higher than the ten-year Treasury rate. In July 2007, before the credit problems became widely known, the 30-year-mortgage rate was 6.63 percent, just 1.63 percent higher than the ten-year Treasury, which was yielding 5 percent. By January 2008, the ten-year Treasury had fallen to 3.91 percent, but the mortgage rate was at 6.07 percent. The spread had widened to 2.16 percent. The spread widened further to 2.34 percent in July 2008. And by the end of December 2008, the ten-year Treasury had fallen to 2.25 percent. The 30-year mortgage, however, had only fallen to 5.14 percent. The spread had risen to 2.89 percent.

Why did the mortgage spread increase after the government intervened? In my opinion this reflects a complete lack of confidence in the financial integrity of Fannie Mae and Freddie Mac.

The government has now nationalized these two institutions. Why not go ahead and make the government guarantee on "Frannie" bonds explicit? Just tell the world that for the foreseeable future Frannie mortgage bonds are guaranteed by the full faith and credit of the U.S. government. This would drop mortgage rates substantially and let all Americans refinance their homes at a very low rate.

On the last day of 2008, the ten-year Treasury rate had dropped to 2.25 percent. This should create an opportunity for all Americans to refinance with a 30-year mortgage around 3.75 percent.

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No matter how complex this situation appears to be, it can be reduced to supply and demand. In the housing market, we've got too much supply and inadequate demand. We need public policies that address these fundamental wounds in the U.S. economy. Simply printing money is a temporary bandage that only delays the inevitable.

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THE TAKEAWAY

The problems in the housing market are the result of too much supply and not enough demand. Construction of new homes in oversupplied markets should end. Investors should be encouraged to purchase vacant homes for rental purposes. And the government should guarantee Fannie and Freddie mortgage bonds to restore faith in those entities.

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