





The market in mortgage-backed security currently exceeds \$6 trillion.

The housing bubble collapse could lead to a loss of 3.6 to 4.5 percentage points of GDP due to a drop in *housing construction* and reversal of the bubble's *wealth effect*.

## **5. The collapse of the housing bubble will throw the economy into a recession, and quite likely a severe recession.**

Housing construction is equal to approximately 5 percent of GDP. Construction of new homes has been going on at a near-record pace over the last few years, in response to the run-up in housing prices. Home construction could easily fall back 40 percent (this was the drop off in the 1981-82 recession), which would imply a direct loss in demand equal to 2 percentage points of GDP.

In addition, the large wealth effect associated with the housing bubble, which has spurred a consumption boom in the last few years, will go into reverse as housing prices plummet. Research from the Federal Reserve Board shows that a dollar in additional housing wealth leads to 4 to 6 cents of annual consumption. This implies that a loss of \$5 trillion in housing wealth would lead to a decline in annual consumption of between \$200 billion and \$300 billion. This loss in consumption is equivalent to 1.6 to 2.5 percentage points of GDP.

Combining the 2 percentage point drop in demand due to a falloff in *housing construction* with the 1.6 to 2.5 percentage point drop in demand due to the reversal of the housing bubble's *wealth effect* leads to a falloff in demand of between 3.6 and 4.5 percentage points of GDP. If employment fell in the same proportion, this would imply the loss of between 5.0 million and 6.3 million jobs. Since the federal government is already running a large deficit, and the country is running a very large trade deficit, the government's ability to use fiscal and monetary policy to boost the economy out of the recession will be severely restricted.

## **6. The collapse of the housing bubble is likely to put major strains on the financial system and require a federal bailout of the mortgage market.**

The collapse of the housing bubble is likely to lead to record levels of mortgage defaults. The ratio of home equity to home value stands at near-record lows, even though the run-up in home prices translates directly into additional equity. The reason for the low ratio of equity to value is that many homeowners have been quick to borrow against the new equity created by the housing bubble. This means that when home prices fall, many homeowners will find that their mortgages equal or exceed the value of their house, giving them a strong incentive to default on their mortgage and simply turn over their house to the mortgage holder.

Of course, if the economy is in a recession, then many homeowners will have no choice but to default on their mortgages. Rising house prices have led many homebuyers to stretch themselves as far as possible to be able to afford monthly mortgage payments. Losing a job or being forced to take a new job at lower pay will leave many recent homebuyers unable to make their payments. Similarly, if interest rates rise, as virtually all economists expect, homebuyers with adjustable rate mortgages will find themselves paying much more on their monthly mortgages. Many homeowners will be unable to make these higher payments.

If there is a large increase in the rate of mortgage defaults, then the mortgage holders will experience big losses. While many banks and financial institutions still hold large amounts of mortgage debt, most mortgages become the basis for mortgage-backed securities, a market that now exceeds \$6 trillion. This market will be put in danger by a large wave of defaults following the collapse of the housing bubble. It is likely that the federal government will have to bail out the market in mortgage-backed securities to prevent a cascading series of defaults.

## **7. The sooner house prices drop, the less economic damage there will be.**

Given how far out of line house prices have grown from fundamentals, there is no way to avoid enormous economic damage when the bubble collapses. However, the quicker house prices revert to more normal levels, the less damage there will be.

As long as prices remain high, more people will buy into homes at bubble-inflated prices. Every week, approximately 140,000 families across the country buy a house. Most of these home purchases occur in the bubble regions. Homeowners who see the price of their home soar in the bubble and then fall back in the crash are not harmed (although they may be unhappy that they didn't sell at the peak). On the other hand, people who buy a home at a bubble-inflated price - and then see the price plummet in the crash - may lose much or all of their savings. The sooner the bubble bursts, the fewer the number of people who will be in this situation.

In addition, if people are borrowing against the bubble-inflated value of their homes, they may come to regret the level of debt they have acquired once they realize that the equity in their home is less than they thought. The baby boom cohort, currently ages 41 to 59, is nearing retirement. Many baby boomers have done very little saving because they believe that they have a large amount of equity in their home. The sooner the bubble bursts, the less borrowing will occur, leaving people better prepared to pay for their retirements.

Rents increased slightly faster than the overall rate of inflation from 1998 to 2002, but have been falling behind inflation in the last two years.

Nationwide vacancy rental rate is at all-time high.

Some regions of the U.S. have experienced a 60 percent increase in real home prices.

Also, the longer the bubble persists the greater the number of questionable mortgage loans. The future rate of mortgage defaults will be higher the longer it takes to burst the bubble. For these reasons, and others, it would be better for the economy if house prices adjusted quickly to more normal levels.

## **8. The housing bubble could pop from higher interest rates, but it could also deflate even if interest rates stay low.**

The fact that mortgage rates fell to a fifty-year low, and have stayed low, has been an important factor in propelling the bubble. The low mortgage interest rates of 2003 were largely the result of deliberate action by the Federal Reserve Board to prop up the economy in the wake of the stock market crash. However, mortgage rates have remained low, even as Alan Greenspan has raised interest rates, primarily because the Japanese and Chinese central banks have intervened in the U.S. treasury market to offset the Fed's actions. By purchasing hundreds of billions of dollars worth of long-term bonds, these central banks have completely offset the Fed's efforts to affect the mortgage market. If the Japanese and Chinese central banks reduce their intervention, or other factors put substantial upward pressure on long-term interest rates, then the housing bubble is likely to unwind.

However, the bubble could begin to deflate even if interest rates do not rise appreciably. The economy is building over 2 million new housing units annually. The demand for housing from new households or second home purchases is probably in the neighborhood of 1.5 million a year. As long as house prices remain at their bubble-inflated levels, construction will stay at its current level or possibly even increase. At the moment, the excess supply of housing is being absorbed by speculators who are convinced that the prices will rise in the future and also by a record nationwide rental vacancy rate. Both sources of demand are limited. There is a limit to the number of people who are willing to speculate in real estate. Also, as excess rental capacity develops, it will put more downward pressure on rental prices, leading more potential homebuyers to rent and causing many landlords to sell off rental units.

It is impossible to say what set of events will cause housing prices to turn (in the absence of a rise in mortgage interest rates), just as it was impossible to determine the set of events that finally led to the bursting of the stock bubble in 2000. However, with supply persistently outstripping demand, it is only a matter of time before house prices eventually adjust.

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<sup>1</sup> The value of residential housing is taken from the Federal Reserve Board's Flow of Funds, Table B102, line 4. The increase in house prices is taken from the Office of Federal Housing Price Oversight's House Price Index, with the CPI-URS being the measure for overall rate of inflation. (June 2004)