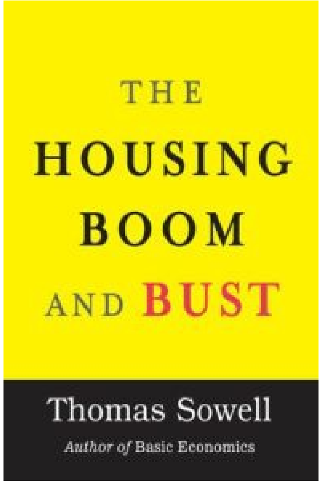

Book The Housing Boom and Bust

Thomas Sowell
Basic Books, 2009
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Recommendation

Economist and political commentator Thomas Sowell provides a readable explanation of the US housing market bubble and its aftermath. His point of view is not in question – it is decidedly on the right, as one might anticipate from a Hoover Institution scholar, so read it with awareness that other experts just as firmly believe opposing views. Sowell lambastes politicians who, he feels, pushed a disastrous policy that made home ownership available to most Americans, including those least able to pay. His style is not always felicitous, but it is accessible, and that is more than you can say for many economists. *BooksInShort* thinks that anyone who wants to understand the housing market that contributed to the 2008-2009 economic crisis will find this illuminating.

Take-Aways

- Home equity is the average American's biggest investment asset.
- The US never had a nationwide housing affordability problem.
- The US has experienced lower housing prices than other developed markets.
- Certain government policies led to the 2008 housing boom, bust and the subsequent economic crisis.
- For instance, land restrictions and other laws kept some home prices artificially high.
- Rep. Barney Frank and Sen. Christopher Dodd blocked attempts by President George W. Bush to tighten regulations on Fannie Mae and Freddie Mac.
- Low interest rates and a national policy of expanding home ownership meant that many people who bought houses couldn't afford them.
- The most complex mortgages often went to the borrowers least able to understand them: uneducated, low-income, first-time home buyers.
- The unintended consequences of making home ownership too widely available included the housing bust, bank failures and the ensuing economic crisis.
- Recovery from the Great Depression came not because of but in spite of the New Deal.

Summary

Dramatis Personae

The housing bubble was not a well-coordinated performance. The main troupe of actors included the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Reserve, the US Department of Housing and Urban Development (HUD), and Wall Street investment houses that turned mortgages into securities. The supporting cast members included those who promoted affordable housing and backed government action to eliminate alleged bank "redlining" (or investment exclusion) of minority neighborhoods. But the cast had no director, and the actors did not work from the same script. Each improvised, pursued its own objectives and responded to its own audience. The result was the housing boom, bust and ensuing economic crisis.

American Dream

Equity in a home is the biggest investment most American homeowners will ever hold, usually 42% of "the household's total net worth," and mortgage borrowing accounts for four-fifths of their debt, according to the Federal Reserve. Housing is a big budget item for renters as well as for buyers. However, borrowers' housing expenses vary with interest rates, which in turn vary with economic conditions, government policy and the borrower's credit rating. High interest rates and high down payments have traditionally been big obstacles to achieving the home-ownership part of the American Dream.

> "To single out home ownership or any other goal as the crusade of the day – as a 'good thing' – ignores the fact that virtually nothing is a good thing categorically."

However, in the early 2000s, interest rates dropped to extraordinarily minimal levels as financial institutions developed creative, risky new instruments that allowed low down payments or none at all. This brought many more people into the housing market to live the Dream. But as mortgages became more obtainable, housing prices soared to record highs. While the economic fallout from the housing bust was global, local factors drove and eventually burst the housing bubble.

> "The record-breaking housing price rises that preceded the record-breaking housing market collapse were not evenly spread across the United States but were heavily concentrated in a relatively few places."

At the boom's height, the top 10 areas for price jumps were all in California, even though home prices there once followed national norms. Why did California prices suddenly jump so far out of range? The cost of construction does not differ much from market to market, so the explanation resides in the price of land and the impact of land-use policies. The 1970s laws that California implemented restricting the use of land had the effect of diminishing the amount of available, buildable land. So, in the early 2000s, rising demand met a shrinking supply of land.

> "First-time buyers have also more often than others resorted to various 'creative' – and risky – methods of financing the purchase of a home."

The US as a whole does not have a shortage of real estate. Nine-tenths of its land is undeveloped. The housing bubble concentrated in a few regions where government policy, especially land use restrictions, artificially shrank the supply of land for building homes. Laws varied from growth-management rules to regulations that mandated turning vacant land into "open spaces," and requirements defining minimum lot sizes and limiting housing density. Cities such as Houston that didn't have land-use restrictions and towns that lacked zoning laws did not endure the skyrocketing housing prices that California did.

> "Some of the least knowledgeable and least experienced home buyers were now financing their purchases with some of the newest and most complicated mortgages."

Throughout the US and the world, governmental intervention consistently has resulted in less housing that is affordable. US housing has, on the whole, experienced less government intervention and, therefore, lower housing prices than other developed markets, such as Great Britain. Curiously, affordable housing advocates prefer to use laws and policies to force the government to subsidize more low-priced housing or to compel the private sector to charge less. Yet these advocates rarely attack land-use restrictions, which are the real cause of unaffordable housing.

Policy Mischief

While some policies shrank the supply of housing, others pumped up demand. Both US political parties believed home ownership was an unalloyed good that policy makers should support for its own sake. The concept of "affordable housing" followed logically: If the market was not making homes affordable to lower-income people, government should act. So government did. Congress gave its mortgage-funding institution (Fannie Mae) bipartisan support, and the agency responded with patronage, political action committee donations and, most important, construction jobs.

> "Politicians in Washington set out to solve a national problem that did not exist – a nationwide shortage of 'affordable housing'."

Legislators pressured banks – particularly through the Community Reinvestment Act of 1977 (CRA) – to make mortgages to people they would not have otherwise seen as qualified for loans. Banks are in the business of making money and have a strong incentive to lend only to those who can pay a loan back with interest. Charges that minorities encounter biased lending policies continue to surface with a powerful impact on politics.

> "Riskier loans were accepted as good loans by one of the key regulators of the housing markets."

Political leaders, the National Association of Homebuilders and the Urban League defended lowering the qualifications for obtaining a mortgage. Fannie Mae and Freddie Mac relaxed their standards as early as the 1990s. When HUD became Fannie Mae and Freddie Mac's regulator in 1992, it established a quota for "affordable housing" loans. This endangered not just Fannie and Freddie but the financial market as well. In 2003, President George W. Bush signed the "American Dream Downpayment Act," providing government funds to help low-income and minority borrowers make home down payments. In effect, this reduced or even eliminated the home buyer's responsibility for the down payment and led to increased riskiness of mortgages.

> "Whatever the merits...of the logic or evidence on which charges of biased lending were based, the political impact of such beliefs has been powerful."

From 2005 to 2007, as many as 40% of the mortgages Fannie and Freddie purchased were subprime or otherwise nontraditional. When economists – including author Thomas Sowell as well as Alan Greenspan and John W. Snow, US Treasury Secretary – warned of the dangers that were arising from housing finance, but Congress gave them the brush-off. These economists all cited Fannie and Freddie as sources of systemic risk. Representative Barney Frank, in 2003 the ranking member of the House Committee on Financial Services, dismissed these fears, as did Senator Christopher Dodd, chairman of the Senate Banking Committee. In July 2008, Dodd said Fannie and Freddie were "on a sound footing."

Financial Engineers

Financial engineers developed clever tools and techniques to allow people who might not previously have qualified for loans to take out mortgages and buy houses. Since expanding home ownership was the policy of the federal government, they had the regulatory wind at their backs.

> "Home buyers in a variety of circumstances now had reasons to default on their mortgages – and they proceeded to do so, whether they had to or whether they simply chose to."

Such financial engineering led to "interest only" mortgages and a variety of adjustable rate mortgages (ARMs), which allowed more people to enter the housing market during a period of low interest rates. Since housing prices were rising rapidly, borrowers could own equity in a home before they even made a payment toward the principal. In this climate, ARMs encouraged people to buy homes and flip them to the next buyer while earning cash on the sale. Home equity loans, "cash out" refinancing and "reverse mortgages" all allowed homeowners to profit in a rising market. Income tax rules also encouraged borrowing against equity, because loan payments were tax deductible.

> "Bad ages to live through are good ages to learn from."

One survey found that more than a fifth of people who bought US homes in 2005 and 2006 were not planning to live in them. They were speculators. Housing speculation creates problems for banks and buyers either when the buyers acquire multiple properties, or when they hold interest-only mortgages whose payments notch up just as the market cools or falls.

> "The study of history is a powerful antidote to contemporary arrogance." (British historian Paul Johnson)

Once the housing market expanded, new buyers – less educated, lower-income people – stepped in, but they faced some of history's most complicated mortgage products. Since subprime loans were new, investors had no history to consider in trying to determine their risk, and new subprime borrowers were disproportionately members of minority populations, many with no previous home-buying experience. Nonetheless, the value of subprime loans more than quintupled from $65 billion in 1995 to $332 billion in 2003.

> "The bedrock question then is: Why did so many monthly mortgage payments stop coming?"

Moody's and Standard & Poor's had limited data to use in rating financial instruments based on new or exotic mortgages. When they gave favorable ratings for such instruments, investors felt more secure than they should have, and then they were caught short. In sum, blaming "predatory lending" for the housing bubble and its aftermath is simplistic. Borrowers, lenders, the government and the financial markets were all responsible for it; they acted irresponsibly and contributed to the disaster.

The Bust

The housing bust began in 2004 when the Federal Reserve raised interest rates. Mortgage rates took the cue and rose. A fall in housing prices ensued in 2006, with prices falling more sharply in areas where utilization of creative financing was highest.

> "And the bedrock answer is: Because mortgage loans were made to more people whose prospects of repaying them were less than in the past."

In 2007, Federal Reserve chairman Ben Bernanke announced that foreclosures had skyrocketed to 320,000 in the first two quarters of the year, compared with an average of 220,000 for each of the previous six years. Half the sales of existing homes in the San Francisco Bay area in December 2008 were foreclosed properties that banks marketed at rock-bottom prices. A pattern of absentee ownership, a sign of speculation, marked foreclosures in California, Nevada, Arizona and Florida.

> "Whether we look at the American economy in general or the housing market in particular, we see a history of remarkable progress for generation after generation – and a few recent years when things turned very bad, very quickly."

By contrast, other areas fared quite well. "Despite drastic declines in home prices in some areas, the nationwide housing price decline was somewhere between 2% and 9% in 2007, depending on what index was used." In Dallas, where only 13% of average income went to housing, home prices went down only 3%. Those who held traditional mortgages were not affected by high mortgage rates, but by the decline in prices. Existing homeowners who did not have subprime loans or ARMs began to question the wisdom of paying off mortgages that exceeded the value of their properties in the now-fallen market. Many decided to do what made economic sense – default and let the bank take the property.

Defaults, whether by subprime borrowers who could no longer afford to pay their mortgages or by strategic defaulters who could afford to pay but chose not to, had fallout on Wall Street. Mortgages were parts of complex securities held by investors all over the world. Defaults sent the value of those securities down, threatening or even erasing such well-respected institutions as Bear Stearns, Merrill Lynch and Citibank.

Consequences and Admonition

The economic dislocation that followed evoked memories of the Great Depression, and some advocates called for emulating the example of the New Deal. However, supposing that New Deal policies brought America back to prosperity is a mistaken conclusion. Government spending to put people to work through government programs had consequences, particularly since the government took the resources it directed from the private sector. In this case, unforeseen government intervention created uncertainty and people stopped spending their money.

The establishment of new institutions changed the economic landscape, creating immense uncertainty, which, in turn, discouraged investment and delayed recovery. World War II – not the New Deal – ended the Great Depression by ending this uncertainty. With a war to fight, instead of attacking business, the Roosevelt administration worked with business, offering cost-plus contracts to manufacturers of material needed for the prosecution of the war.

Emulating New Deal policies in order to deal with the present crisis would be rash. Such rashness is too risky. Former Obama White House Chief of Staff Rahm Emanuel [now mayor of Chicago] famously said, "You never want a serious crisis to go to waste." Those are dangerous words. America should be wary of any insufficiently thought-through set of policies that bring even more government intervention into the economy. The housing market boom and bust ought to have taught Americans a lesson about the unintended consequences of such intervention.

About the Author

Thomas Sowell has taught economics at Cornell, UCLA, Amherst and other academic institutions. His *Basic Economics* text has been translated into six languages. He is currently a scholar in residence at the Hoover Institution, Stanford University.