Fixing America’s Housing Market

Current U.S. policy is befuddled.

A sure sign of a dysfunctional market economy is the persistence of unemployment. In the United States today, one out of six workers who would like a full-time job can’t find one. It is an economy with huge unmet needs and yet vast idle resources.

The housing market is another U.S. anomaly: there are hundreds of thousands of homeless people (more than 1.5 million Americans spent at least one night in a shelter in 2009), while hundreds of thousands of houses sit vacant. Indeed, the foreclosure rate is increasing. Two million Americans lost their homes in 2008, and 2.8 million more in 2009, but the numbers are expected to be even higher in 2010. Our financial markets performed dismally—well-performing, “rational” markets do not lend to people who cannot or will not repay—and yet those running these markets were rewarded as if they were financial geniuses.

None of this is news. What is news is the Obama administration’s reluctant and belated recognition that its efforts to get the housing and mortgage markets working again have largely failed. Curiously, there is a growing consensus on both the left and the right that the government will have to continue propping up the housing market for the foreseeable future. This stance is perplexing and possibly dangerous.

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The mortgage market is never mentioned. Mastering the specific information related to assessing creditworthiness and monitoring the performance of loans is precisely the kind of thing at which the private sector is supposed to excel.

It is, however, an understandable position: both U.S. political parties supported policies that encouraged excessive investment in housing and excessive leverage, while free-market ideology dissuaded regulators from intervening to stop reckless lending. If the government were to walk away now, real-estate prices would fall even further, banks would come under even greater financial stress, and the economy’s short-run prospects would become bleaker.

But that is precisely why a government-managed mortgage market is dangerous. Distorted interest rates, official guarantees, and tax subsidies encourage continued investment in real estate, when what the economy needs is investment in, say, technology and clean energy.

Moreover, continuing investment in real estate makes it all the more difficult to wean the economy off its real-estate addiction, and the real-estate market off its addiction to government support. Supporting further real-estate investment would make the sector’s value even more dependent on government policies, ensuring that future policymakers face greater political pressure from interest groups like real-estate developers and bond holders.

Current U.S. policy is befuddled, to say the least. The Federal Reserve Board is no longer the lender of last resort, but the lender of first resort. Credit risk in the mortgage market is being assumed by the government, and market risk by the Fed. No one should be surprised at what has now happened: the private market has essentially disappeared.

The government has announced that these measures, which work (if they do work) by lowering interest rates, are temporary. But that means that when intervention comes to an end, interest rates will rise—and any holder of mortgage-backed bonds would experience a capital loss—potentially a large one.

No private party would buy such an asset. By contrast, the Fed doesn’t have to recognize the loss; while free-market advocates might talk about the virtues of market pricing and “price discovery,” the Fed can pretend that nothing has happened.

With the government assuming credit risk, mortgages become as safe as government bonds of comparable maturity. Hence, the Fed’s intervention in the housing market is really an intervention in the government bond market; the purported “switch” from buying mortgages to buying government bonds is of little significance. The Fed is engaged in the difficult task of trying to set not just the short-term interest rate, but longer-term rates as well.

Resuscitating the housing market is all the more difficult for two reasons. First, the banks that used to do conventional mortgage lending are in bad financial shape. Second, the securitization model is badly broken and not likely to be replaced anytime soon. Unfortunately, neither the Obama administration nor the Fed seems willing to face these realities.

Securitization—putting large numbers of mortgages together to be sold to pension funds and investors around the world—worked only because there were rating agencies that were trusted to ensure that mortgage loans were given to people who would repay them. Today, no one will or should trust the rating agencies, or the investment banks that purveyed flawed products (sometimes designing them to lose money).

In short, government policies to support the housing market not only have failed to fix the problem, but are prolonging the deleveraging process and creating the conditions for Japanese-style malaise. Avoiding this dismal “new normal” will be difficult, but there are alternative policies with far better prospects of returning the U.S. and the global economy to prosperity.

Corporations have learned how to take bad news in stride, write down losses, and move on, but our governments have not. For one out of four U.S. mortgages, the debt exceeds the home’s value. Evictions merely create more homeless people and more vacant homes. What is needed is a quick write-down of the value of the mortgages. Banks will have to recognize the losses and, if necessary, find the additional capital to meet reserve requirements.

This, of course, will be painful for banks, but their pain will be nothing in comparison to the suffering they have inflicted on people throughout the rest of the global economy.

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