SATURDAY, MAY 28, 2011

Zandi: Housing market's problems remain

The five-year-long housing crash is not over. Nationwide, prices have fallen a stunning 33 percent from their peak. While the Philadelphia area's housing market has held up as well as any in the country, prices in this region are off 17 percent. Given the millions of foreclosure and short sales in process nationwide, house prices will decline further.

It is hard to be enthusiastic about the economy's prospects as long as house prices are falling. A house is most families' most important asset, and the crash has cost the typical American homeowner nearly $85,000 in housing wealth. The loss is particularly hard on middle-income households, who have benefited less than their higher-income neighbors from rising stock prices.

Shaky house prices have also made it difficult for the owners of small businesses to use their homes as collateral. Bank lending to small businesses has picked up over the past year, but it is hard to see how credit will flow freely until house prices rise again. Since small businesses are a key part of job creation, this is a significant impediment to a stronger job market.
Local governments, meanwhile, struggle as falling house prices hit property-tax revenues.

Despite rising millage rates in many parts of the country, tax revenue is growing near its slowest pace on record. Given the lag between market price changes and tax assessments, revenues are likely to slow even more in the coming year. Local governments thus have little choice but to continue cutting budgets and laying off workers.

Most worrisome is the risk that housing will resume the vicious cycle seen at the depths of the Great Recession, when falling prices pushed more homeowners under water — their loans exceeded their homes' market values — causing more defaults, more distress sales, and even lower prices.

With an estimated 14 million homeowners already in this predicament, such a cycle is a real possibility. Adding to the concern, the average underwater mortgage exceeds the property's market value by nearly $50,000. It wouldn't take much to persuade many people in that situation to send their keys back to lenders; a leaky roof or a broken air conditioner could be the trigger, particularly if rental housing is available nearby for less than the cost of a mortgage.

Decisions to default depend critically on expectations about future house prices. If homeowners think prices will rise, they are more likely to hold on; if they believe more price declines are coming, they are likely to give up. This can quickly become a vicious cycle, as occurred during the depths of the recession. That cycle was only broken after a massive policy effort by the Federal Reserve, Congress, and the Obama administration, including the government takeover of Fannie Mae and Freddie Mac as well as three rounds of housing tax credits.

Because the risks of another downward spiral are so high, policymakers should consider providing additional temporary help to the housing and mortgage markets. Most immediately, Congress should delay a decline in conforming mortgage loan limits, which is set to occur in October. The limits will restrict future lending by Fannie Mae, Freddie Mac, and the FHA, three agencies that currently make nearly all of the nation's mortgage loans.

The limits were raised during the recession to help the government fill the void left by the collapsing private lending market. The higher limits were never intended to be permanent, but it would be worthwhile for policymakers to extend them for another year.

Without an extension, housing markets in the Northeast, including Philadelphia, as well as in Florida and on the West Coast could face significant reductions in credit. More than a tenth of the mortgage loans made in these areas last year would exceed the lower limits that will take effect unless Congress acts.

Reducing the loan limits is a good test of whether private mortgage lenders are willing and able to step up as the government steps back, but doing so this year may be premature. The nation's largest financial institutions appear to have the necessary capital to increase lending, but homebuyers will have to pay somewhat higher interest rates than they do now, as much as a half percentage point.

But if the test does not go according to plan, mortgage rates could rise much more. This cannot be ruled out, particularly given increased concentration in the mortgage industry since the financial crisis and the greater market power of today's large institutions. There would be no meaningful cost to taxpayers of delaying a reduction in the conforming loan limits, but the cost of a misjudgment to the housing market and economy would be high.

Delaying the reduction in conforming loan limits won't solve the housing market's problems, yet it is still worth doing, because the housing downturn remains the most serious threat to the economic expansion.

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