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Wrong Turn on Housing

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How to rescue housing? The Obama administration doesn't have a plan -- or, more accurately, it has only half a plan. It presupposes that preventing or minimizing home foreclosures is a formula for revival. It isn't.

Almost everyone agrees that a housing recovery is essential for a broader economic upswing, in part because housing's collapse brought on the recession. Mortgage delinquencies triggered the financial crisis. Tumbling home prices (down 26 percent from their peak) ravaged consumer confidence, borrowing and spending. Since late 2007, housing-related jobs -- carpenters, real estate agents, appraisers -- have dropped by 1 million, a quarter of all lost jobs.

Housing's distress is too much supply chasing too little demand. Huge inventories of unsold homes have depressed prices and construction. Given that prices rose too high in the "bubble" -- homes were affordable only because credit was dispensed so recklessly -- much of this painful adjustment was unavoidable. But that process should be mostly complete.

Here's a little-known fact: Housing may be more affordable now than at any recent time, thanks to lower prices and falling mortgage rates (now about 5 percent). The National Association of Realtors has an "affordability index" that estimates the family income needed to buy a median-price house, assuming a 20 percent down payment and monthly mortgage payments equal to 25 percent of income. Affordability is now the highest since the index's start in 1970.

Unfortunately, demand hasn't followed affordability. In January, sales of new and existing homes continued prolonged declines, dropping 10.2 percent and 5.3 percent, respectively, from December. There's a buyers' strike. Why? Shouldn't lower prices spur demand?

Well, yes. There are many theories as to why they haven't. Perhaps prospective buyers can't get loans. Or people are so gloomy that they're afraid to buy. But the most important explanation is probably deflationary psychology. If yesterday's \$250,000 house is now \$200,000, it may be \$175,000 by June. Waiting is better.

Unless such deflationary psychology is broken, it becomes self-fulfilling. The more buyers wait, the more prices fall; and the more prices fall, the more buyers wait. The Obama administration essentially ignores this problem, though it can be addressed.

The simplest way is to bribe prospective buyers not to wait. For example: Give them a 10 percent tax credit, up to \$15,000, on the purchase of a new home. Anyone who bought a \$150,000 home would get a \$15,000 tax break. The credit would expire in a year. Waiting would be costly. Buyers would delay only if they thought home prices would drop as much or more.

Precisely this proposal comes from the National Association of Home Builders. Normally, it would be an atrocious idea, because it would reward people who would buy anyway and would be skewed toward wealthier buyers. But now it's worth trying.

Somehow, we need to cut bloated inventories (13 months of supply for unsold new homes), curb falling prices and stimulate new construction. The hope is that once buying improves, it would feed on itself. People would join from the sidelines. The NAHB says its plan would create 250,000 jobs and cost \$40 billion -- big money, but tiny compared with the hundreds of billions lavished on recovery programs. The Senate included the plan in its stimulus, but it was later dropped.

It wasn't an Obama priority. Some administration proposals, focused on foreclosures, are desirable. It's sensible to allow Fannie Mae and Freddie Mac to refinance older mortgages, at lower interest rates, even if homeowners' equity has dropped below today's requirement of 20 percent. This would reduce defaults and increase borrowers' spending power.

Other ideas seem more dubious. For \$75 billion, another proposal would subsidize homeowners so their monthly mortgage payments dropped to 31 percent of their income. Because that's still high, many of these homeowners would probably default anyway. Even worse is the "cramdown" proposal, backed by the administration. This would allow bankruptcy judges to cut mortgage payments. If passed, this would probably raise future mortgage costs because lenders would have less access to collateral.

In any case, minimizing foreclosures alone won't revive housing. If the recession and unemployment worsen, foreclosures will increase, because people without jobs and income can't make their monthly payments.

The best way to limit foreclosures is to promote an economic recovery by stimulating home buying. It's true that the recent "stimulus" plan included a tax credit of up to \$8,000, but that was restricted to first-time buyers and made "refundable," meaning people could receive the money even if they didn't owe taxes. These are younger and poorer buyers -- the weak credit risks of today's crisis. They won't rescue housing.

All this is telling. The administration and Congress, though pledging to restore economic growth, care more about protecting foreclosure victims and promoting homeownership among the young and poor. Politics trumps economics.