The Key to Stabilizing House Prices: Bring Them Down

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December 2008

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Executive Summary

The housing bubble created more than $8 trillion in bubble wealth. The collapse of this bubble is throwing the economy into a severe recession and shaking the foundations of the financial system. Many economists believe that the stabilization of house prices is essential to economic recovery.

However, prices in many markets are still hugely out of line with trend levels, as measured by price-to-rent ratios. As long as house prices remain inflated, there is no way that the market can stabilize since there will continue to be a large excess supply of housing putting downward pressure on house prices.

The best way to stabilize house prices in these bubble markets is to deflate the bubbles. This can be accomplished by having the government-sponsored enterprises (GSEs – Fannie Mae, Freddie Mac, and Ginnie Mae) refuse to buy mortgages in markets where house prices continue to be out of line with rents. Since the rest of the secondary market has collapsed, if the GSEs refused to buy mortgages in these markets, it would quickly force issuers to curtail loans. This should lead house prices to adjust rapidly to their trend level.

In addition, by diverting mortgage loans to non-bubble markets, the GSEs should help to support the housing market in these areas and prevent a downward spiral. A rapid adjustment in house prices should also allow homeowners to more quickly recognize their actual financial situation.

There should be protections for the people who will face foreclosure at least in part as a result of the loss of equity. The best way to help these people is to temporarily change the rules on foreclosures to give homeowners the option to remain in their house as renters. This will give homeowners security in their home and will also give banks a real incentive to negotiate terms that allow homeowners to stay in their house as owners.[1]

The GSEs badly failed the public by providing capital to the housing sector that helped fuel the bubble. They can play a much more positive role now by following a policy that explicitly seeks to deflate the bubble.

1 See Baker, D. 2008. "Subprime Borrowers Deserve an Own to Rent Transition," *The Economists' Voice*, V. 5, #1 available at http://www.bepress.com/ev/vol5/iss1/art5/.

Introduction

Many economists and policymakers have argued that it will not be possible to stabilize the economy until the housing market is stabilized. While this is somewhat of an exaggeration – housing is a hugely important sector, but if the economy were otherwise healthy it could overcome instability in the housing market – it would be desirable to quickly bring stability to the housing market.

The best way to accomplish this goal would be to fully deflate the bubble by bringing house prices back to their trend level. As a result of its ownership of Fannie Mae and Freddie Mac, the government has within its power all the tools it needs to accomplish this task.

Due to the collapse of the private market for issuing mortgage-backed securities, the government has almost complete control of the secondary market through Fannie Mae, Freddie Mac, and Ginnie Mae. The lending standards that it imposes on these institutions will therefore be the criteria for an issuer to be able to sell a mortgage in the secondary market.

This means that the government can effectively impose guidelines for almost all new mortgages. Even in normal times, the vast majority of mortgages were issued for resale in the secondary market. In the current environment, very few banks will be interested in issuing a mortgage that they cannot sell in the secondary market.

The key rule would be that the house prices used in mortgage appraisals be based on rental values. While real house prices increased by more than 80 percent in the decade from 1996 to 2006 according to the Case-Shiller national index, real rental prices increased by just 4.0 percent over this period.[2] This gap suggests the extent to which house prices were driven by speculation rather than the fundamentals in the housing market.

The GSEs could effectively ensure that they are only issuing mortgages that are supported by the fundamentals in the market, if they use a price that is equal to 15 times the annual market rent as the appraised value of the home. This can be done by either requiring a direct appraisal of the rental value of the home or by adjusting the appraised sale price in accordance with the gap in the metropolitan area between the current price-to-rent ratio and the 15 to 1 ratio.

For example, if the current sale price-to-rent ratio for comparable units is 20 to 1 in a market that is still inflated by the housing bubble, then the appraised sale price of any house in this area would be adjusted down by 25 percent to bring it in-line with its trend level.[3] In some areas it may be

2 The Case-Shiller National Index is available at http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_csmahp/0,0,0,0,0,0,0,0,0,1,4,0,0,0,0,0.html index used in this measure is the Bureau of Labor Statistics' owners' equivalent rent index.

3 See Rho, Hye Jin, Danilo Pelletiere, and Dean Baker, 2008. "The Changing Prospects for Building Home Equity: An Updated Analysis of Rents and the Price of Housing in 100 Metropolitan Areas," Washington, D.C.: Center for Economic and Policy Research, available at http://www.cepr.net/index.php/publications/reports/the-changing-prospects-for-building-home-equity/

appropriate to use a slightly higher or lower ratio of sale to rental prices based on factors specific to the metro region that may have caused a long-term divergence from this ratio.[4]

The Impact of Rent-Based Appraisals

If the GSEs insisted on rent-based appraisals (either directly or indirectly through the method described above) it would almost immediately make it impossible to get financing to sell houses at bubble-inflated prices. This would mean that prices in the bubble-inflated markets (primarily those on the West Coast, Florida, and the East Coast north of Washington, D.C.) would very quickly adjust to their trend levels, dropping by 20-30 percent from current levels.

At the new lower prices, homebuyers would be less fearful that there would be a further decline in prices. This should cause many potential homebuyers – who have been waiting for the price decline to stop – to re-enter the market. Bringing prices back to their trend level is the most effective way to boost demand in the market and to begin to reduce the record vacancy rate.

By at least temporarily shifting mortgage capital away from bubble-inflated markets, this policy should also help to shore up housing markets that are not inflated, as mortgage loans would shift to these regions. This should lower mortgage interest rates in the non-bubble markets, boosting demand. In addition, there should be a psychological boost to these regions as a direct result of the GSEs' willingness to make loans based on current market prices. This will provide greater assurance to homebuyers that they are unlikely to incur large losses on their houses.

The effect of the increased flow of mortgage loans to the non-bubble markets should help to place a floor on house prices in these markets and prevent a downward spiral below trend levels. The same would hold true in the current bubble markets once house prices have returned to trend levels.

The sharp drop in house prices in the bubble-inflated markets that would result from this action will also benefit the economy. The losers in this scenario will be the current homeowners who might otherwise have been able to limit the loss on their house by selling it before the bubble completely deflated. The flip side of this story is that prospective homeowners are saved from buying homes at bubble-inflated prices on which they will subsequently lose money.

The other important advantage of a rapid decline in house prices to trend levels is that homeowners will have a better sense of their real wealth and will be able to adjust their consumption/saving decisions accordingly. If homeowners will lose most of their home equity over the next year, it is better that they recognize this fact as soon as possible so that they can adjust their behavior accordingly. This is especially important for the huge baby boom cohorts approaching retirement, many of whom will find that they have virtually no wealth other than their Social Security benefits to support them in retirement.

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4 Alpert (2008) examines historic price-to-rent ratios in major metropolitan areas. This sort of analysis can be applied more generally to determine whether specific factors may warrant a long-term divergence from this 15 to 1 ratio. See Alpert, Dan, 2008. "Putting a Floor Under American Homes: How Low Do We Go?" Westwood Capital, LLC. Available at http://www.westwoodcapital.com/articles/Putting_a_Floor_Under_American_Homes_Alpert_081208.pdf.

The rapid decline in house prices will undoubtedly increase the number of mortgages that default, but this would mostly just be hastening the inevitable. Homeowners are not obviously worse off if their house price falls 25 percent tomorrow than if it falls 25 percent over the next year. The main difference is that in the former case, the homeowner has more opportunity to adjust to their lost equity.

To assist homeowners who are faced with the loss of their home – partly as a result of falling house prices – the best remedy is to temporarily change the rules on foreclosure to give homeowners the right to rent their home at the market rate for a substantial period of time (e.g. 10-20 years). This would give homeowners security in their home so that if they liked the house, the neighborhood, or the schools for their children, they would have the option to stay there. This would also keep the home occupied so that the neighborhood does not deteriorate due to a large number of vacant properties.

Perhaps most importantly, a right to rent would give bankers a real incentive to negotiate terms under which homeowners can stay in their house as owners. Banks will not be anxious to become landlords, and making foreclosure a much less attractive route for banks means that they will be far more likely to pursue alternative remedies.[5]

Banks and other holders of mortgages or derivative instruments will also be hurt by the additional losses, but this is, again, just a matter of timing. If the decline in house prices was going to lead a homeowner to default, making the decline in prices happen sooner may move up the default date, but it is not likely to lead to a large net increase in defaults.

Government-Controlled House Prices?

There may be some objections to the policy of rapidly deflating the bubble based on the idea that the government should not be dictating house prices. Such objections are misplaced, because the government is already playing a large role in determining house prices through the lending decisions of the GSEs, even if this has not been the result of conscious policy.

The decision to buy mortgages on homes purchased at bubble-inflated prices effectively supports those bubble-inflated prices. This means that the current government policy is one of maintaining a housing bubble. There is little basis for arguing that it is acceptable for the government to try to maintain bubble-inflated prices, just because the outcome is not explicit policy. Ignorance of a policy's effect cannot make the policy better.

In fact, if the GSEs had acted responsibly in the run-up to the bubble, they would have curtailed lending in the bubble-inflated markets. They would have either demanded higher down payments in these markets or simply refused to buy mortgages issued in these markets.

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[5] In addition to Baker, D. 2008. "Subprime Borrowers Deserve an Own to Rent Transition," *The Economists' Voice*, V. 5, #1 available at http://www.bepress.com/ev/vol5/iss1/art5/, see also Alpert, D. 2008. "The Freedom Recovery Plan," Westwood Capital, available at http://www.westwoodcapital.com/opinion/index.php?option=com_content&view=category&layout=blog&id=39&Itemid=61, and Wasow, B. 2008. "A Safety Net for Bubble Buyers: Rescuing Homeowners From Collapsing Home Values," New York: Century Foundation available at http://tcf.org/list.asp?type=PB&pubid=665.

This would have been good policy for the GSEs – they would not have suffered the huge losses that subsequently pushed them into conservatorship – and it would have been good for the country's housing market. The withdrawal of capital by the GSEs in the bubble markets would have almost certainly slowed the run-up in prices. More importantly, it would have drawn attention to the over-valuation of house prices in these markets and might have made other lenders wary of making further loans in these areas. It may also have scared away some potential buyers.

It may not be possible to determine whether or not the GSEs, acting on their own, could have burst the housing bubble at an earlier date, but there would have been no obvious downside to a decision to cut back lending in bubble-inflated markets. It would have been good for the housing market and good for their long-run profitability, although it may have led to a serious loss of market share in the short-run.

Conclusion

The housing bubble was allowed to grow to such dangerous proportions due to a series of major failures of public policy. Somehow, most people in policy positions failed to recognize the bubble. Those who did recognize the bubble were either unable or unwilling to take any action to stem its growth.

Even as the collapse of the bubble is throwing the economy into the worst downturn since World War II, there is still remarkably little public discussion of the housing bubble and the best policy to deal with it going forward. The best policy would be to quickly deflate the remaining bubble markets by restricting the supply of mortgage capital from the GSEs. This will allow for prices to stabilize and enable the housing market to more quickly return to normal.