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There Goes the Neighborhood

Why home prices are about to plummet—and take the recovery with them.

By Benjamin Wallace-Wells

In Washington, where words are the currency, where imprecise verbs threaten the loss of a political career and misapplied nouns can doom a movement, there remain a few figures who get a general pass not just for a certain degree of verbal imprecision, but for a fairly deep-seated degree of intellectual wackiness, a penchant for regularly saying very odd things. Newt Gingrich is one of these public figures, Robert Byrd another; Helen Thomas has her moments, too.

You'll be sitting in the audience listening to a sensible speech by, say, Gingrich, and all of a sudden you get the notion that aliens have captured his brain. Befuddled, you'll turn to your friend next to you, the libertarian true-believer, and he'll shrug his shoulders and whisper back: "Oh, it's just Newt." And then, a few minutes later, the speaker's episode will subside, the aliens return the brain, and the speech continues on its before-we-were-so-rudely-interrupted track. No one says a word. The capital's press gives these folks a pass from its usual lawyerly scrutiny because they are regarded as sages who can be relied upon to speak some kind of unusual and valuable truth, whose occasional episodes of profound intellectual oddness are thought to stem from the same deep source as their general brilliance.

One of these spells flared up during the last week in February, when Greenspan recommended that the home-owning public take a good hard look at switching from fixed-rate mortgages, under whose terms payments stay the same no matter what interest rates do, to adjustable rate mortgages (ARMS), where payments fluctuate along with interest rates—which, right now, makes close to zero sense. Interest rates are lower than they've been in 30 years, and, with all economists predicting a general economic upturn, and Bush's budget deficit and the weak dollar sucking up capital, little doubt exists that interest rates must rise, in which case, switching from a fixed-rate to adjustable-rate mortgage would be pretty costly for any family naïve enough to take Greenspan at his word. The episode did not pass completely without critical notice. It was "the strangest bit of advice ever to be proffered by an American central banker," Jim Grant, publisher of *Grant's Interest Rate Observer*, told the *San Francisco Chronicle*. Then the press moved on: "Oh, it's just Greenspan."

But sometimes wacko ideas can betray deeper truths. It is tempting to ask what stake the chairman might have in trying to convince millions of people to do something so contrary to their own interest. One theory floated by Fed-watchers is that the chairman is trying to help out his classic institutional constituency, the big banks, which hold trillions of dollars in fixed-rate mortgage paper. There may be something to that theory, but there is almost certainly a deeper and more important motive behind this curious advice. Quite simply, Greenspan is trying to keep a wobbly and fragile recovery alive—and using mortgage refinancing to do it.

There are many strange things about the choppy recovery we're in, but among the most curious is that it is being fueled largely by consumer spending. Why consumers should continue to spend, and why they've done it throughout the recession, is not immediately obvious. After all, average income growth has been puny in the last few years. There's been a big falloff in jobs. Health care and tuition costs have only been going up. And the stock market has spent the last three years unsuccessfully huffing and puffing to get back to the level where it was in early 2001. Why have consumers been spending so much?

Economists have advanced two main reasons. One is that Americans have so lost their moorings that they've had few qualms about going deep into debt. That's certainly true. The average person's debt as a percentage of his income is now higher than it's ever been. But there's another reason, too: Americans have been using their homes as ATM machines, refinancing their mortgages in order to fund their spending. This, of course, makes sense. The one sector of the economy that has consistently swelled has been housing prices. This has intrigued and surprised many economists, because housing is supposed to operate in sync with the economy, expanding during flush times and contracting when things go poorly. But even in a down economy, prices have soared.

Because of these rising prices, people have felt that despite all the ups and downs in stocks and salaries, that their overall situation was okay. Homes are the biggest asset most families own, and their value has been rising nicely. For that reason, Americans have felt more comfortable buying big-ticket items, from SUVs to new computers to Disney World vacations. Much of that spending has gone right onto the VISA card. But that debt has been kept somewhat manageable by another factor in housing prices: mortgage refinancing.

With home prices rising and the Fed keeping rates low, a mortgage refinancing industry that barely existed 15 years ago exploded into one of the fastest growing sectors of the financial services industry. Last year, one-third of all homeowners used cash-out mortgages to refinance their homes, a rate roughly consistent over the past five years. Savvy investors, says Harvard economist William Apgar, are likely to have refinanced "two or three times in the last two years." Each time they do, they have either been able to lower their monthly payments, or walk away with a chunk of cash. And where does that extra cash go? The ubiquitous Ditech TV ads say it all: "I just refinanced my home and paid off my credit cards!" American homeowners have gained $1.6 trillion in cash from refinancing in the last five years, and those gains have flowed almost wholly into purchases of consumer goods. The resulting spending, says Wharton's Susan Wachter, is "propping up" the American economy.

Greenspan has played enabler to this boom. But with the Fed fund's rate at 1 percent, the chairman can't do much more to sustain it. Tens of millions of Americans have already refinanced their mortgages, and at current rates, can't be induced to do so again. This small window is closing, fast: For six months, refinancing has been tapering off, and economists expect it to narrow further—many economists have argued the gains from refinancing are likely to halve ths year. Moreover, as soon as interest rates rise (as Greenspan himself has said they will within the next year), virtually all refinancing will cease.

Greenspan's rather ham-handed effort to get them to go for ARMs, is a sign not of the chairman's own eccentricity or advanced age, but, instead, of the economy's current unsteadiness. Greenspan knows, perhaps better than anyone, that this economy is perched nervously on top of a wobbly, Dr. Seuss-like tower. Our recovery is propped up by consumer spending, which is in turn propped up by mortgage refinancing, and if that refinancing dries up before more props can be put in, the whole edifice could fall. "Since long-term interest rates cannot fall low enough to facilitate another wave of fixed-rate refinancings, he is trying to encourage homeowners to refinance one last time: fixed to ARM," Peter Schiff, president of Euro Pacific Capital in Los Angeles told the *San Francisco Chronicle.*

Let's assume for a moment that enough people get fooled, and the refinancing boom gets extended for another year. Then what? The real problem hits. Because if you think Greenspan's being cagey on refinancing, the truth he's really avoiding talking about is that we're in the midst of a huge housing bubble, on a scale only seen once before since the Depression. Worse, the inflated housing market is now in an historically unique position, as the motor of the rest of the economy. Within the next year or two, that bubble is likely to burst, and when it does, it very well may take the American economy down with it.

House bound

Whether or to what extent American home prices will plummet soon is open to some debate, but not much. Even the professionally optimistic housing economists employed by the real-estate industry are now admitting that the good times may be over: "What we would ask for is kind of a slow slowdown," Jeff Culbertson, president of Coldwell Banker-Northern California, told *Knight Ridder* at the beginning of March. Virtually every housing economist is concerned that prices may be unstable, and growing numbers are becoming outright alarmed. To understand why that is—and why warnings of a coming housing collapse haven't been front-page news—just look at the numbers.

Truth is, in most of the country there's no housing bubble. Perhaps the crucial ratio from which economists determine whether housing markets are out of whack is the ratio of home prices to annual income. In most of the country, it is modest, 2.4:1 in Wisconsin, 2.2:1 in Kentucky, 2.9:1 in Illinois.

Only in about 20 metro areas, mostly located in eight states, does the relationship of home price to income defy logic. The bad news is that those areas contain roughly half the housing wealth of the country. In California, the price of a home stands at 8.3 times the annual family income of its occupants; in Massachusetts, the ratio is 5.9:1; in Hawaii, a stunning, 10.1:1. To some extent, there are sound and basic economic reasons for this anomaly: supply and demand. Salaries in these areas have been going up faster than in the nation as a whole. The other is supply: These metro areas are "built out," with zoning ordinances that limit the ability of developers to add new homes. But at some point, incomes simply can't sustain the prices. That point has now been reached. In California, a middle-class family with two earners each making $50,000 a year now owns, on average, an $830,000 home. In the late 80s, the last time these eight states saw price-to-income ratios this high, the real estate market collapsed.

By other measures, too, the market is badly bloated. One index of housing inflation is the difference between house prices and rents. In a healthy market, driven by demand, rents and sale prices ought to track roughly together. But while sale prices have soared, rents have stayed flat; and in some of the most overheated markets, like San Francisco and Seattle, they have actually been declining. Such a gap, the economist and New York Times columnist Paul Krugman has written, suggests "that people are now buying houses for speculation rather than merely for shelter," evidence that he called a "compelling case" for a housing bubble.

"Within the next year or so," *The Economist* argued in a May 2003 editorial, these regional "bubbles are likely to burst, leading to falls in average real home prices of 15-20 percent" across America. And, of course, in the most heated markets the drop is likely to be steeper yet.

When housing bubbles burst, they can hurt more than their sector of the economy. Studies have shown that they exercise twice the effect on consumer spending as comparable declines in stock prices. So, a 20 percent drop in housing prices would have the same, shriveling effect on the economy as a 40 percent crash in the stock market. When investors lose value in their houses, many of them pull money out of other investments, like stocks. Then, too, jobs in construction, real estate, and other fields that depend on new home sales die off.

What can Alan Greenspan or anyone else do about this? The answer is, not much. Prices are so stratospheric that even modest hikes in long-term interest rates could burst the bubble. And with federal deficits soaking up so much capital, interest rates are likely to rise as the economy heats up and demand for capital increases. Of course, Greenspan could argue for rescinding some of President Bush's tax cuts, which he's long defended, to bring down the deficit. But even that probably won't forestall a collapse in home prices.

Given the lateness of the hour, and the near-inevitability of the coming crash, there's really only one thing left for concerned citizens to do. Start assigning blame.

Blowing bubbles

Fortunately, the bad actors responsible for this manic inflation are pretty easy to recognize. They look remarkably like the ones who puffed up the tech bubble in the late 90s. In both cases, the unfettered optimism of the buying public was fueled by a brokerage industry almost wholly concerned with making a sale, independent analysts with an incentive to hype prices, and major accounting fraud.

What drives most appreciation in housing prices is the universal human desire to own a slightly larger and more expensive place than one can really afford; a desire restrained in normal times by the universal desire of those who lend money to get paid back.

Getting a home loan used to be a particularly nerve-wracking and unpleasant process. A stern loan officer behind a big mahogany desk would pore over your income and credit, suspiciously probing your portfolio for weaknesses. And sensibly enough: The bank that lent you the money would have to collect on the mortgage for the next 30 years and had to make sure you were really good for it. It hired independent appraisers to make sure the price was in line. This process was a little stingy, and meant some people on the low end of the income scale couldn't buy a home and many others got less home than they might have wanted, but the system usually kept prices in check.

The one exception to this general process was mortgages sold on the secondary market. In the 1930s, Congress created the Federal National Mortgage Corporation (Fannie Mae) to encourage banks to make loans to low-income Americans by agreeing to purchase those mortgages from the banks. In 1970, Congress created a second agency, the Federal Home Loan Mortgage Corporation (Freddie Mac), to do much the same thing. By the late 1980s, these two entities, which belong to the category known as Government Sponsored Entities (GSEs), were buying up and reselling 30 percent of new mortgages and packaging the mortgages to be sold as securities.

Fannie and Freddie's market share was limited by their ability to attract investment capital. But in 1989, Congress instituted some modest-seeming technical changes that made Freddie and Fannie much more attractive to investors, and able to draw much more capital. Under the new rules, for instance, they were allowed to customize securities at different levels of risk and return to meet more precisely the demands of different sectors of the capital market. Then, too, bank regulators let pension funds and mutual funds class Fannie's debt as low-risk. As a consequence, during the 1990s, investors practically threw money at Fannie Mae and Freddie Mac, which became enormously, steadily profitable. The GSEs used the new capital to buy up every mortgage they could, and banks were only too happy to sell off the mortgage paper. The price cap on the mortgages Fannie and Freddie could insure was raised. As a result of all these changes, Fannie and Freddie went from buying mostly mortgages for low-end homes to those of the middle- and upper-middle class. And the share of the nation's conventional mortgage debt which they insure has swelled, to more than 70 percent today, double its share in 1990.

This shift has had two crucial, if under-appreciated, consequences. First, in little more than a decade, Fannie Mae and Freddie Mac have gone from handling one trillion dollars in mortgages to four trillion, with virtually no changes in oversight. Second, their dominance of the mortgage market has profoundly undermined the discipline that once kept housing prices in check.

Once banks knew they could automatically hand off the mortgages they wrote to Fannie and Freddie with basically no risk, the old incentive system dissolved. "Banks and other mortgage lenders are not watching home prices carefully because they rarely hold onto the mortgage paper they create—they just sell it upstream to mortgage investors," John R. Talbott, a housing researcher at UCLA's Anderson School of Business, has argued.

"It is a dangerous situation indeed when neither home buyers nor the institutions that finance them are concerned with the ultimate price being paid for the housing asset."

In most markets, buyers and sellers rely on independent experts to bring sanity to prices. In the stock markets during the 1990s, that role had traditionally been played by stock analysts, whose opinions were famously bought off by the investment banks they worked for. Something similar has happened to appraisers, the independent contractors banks hire to determine the worth of a home for the purposes of a mortgage loan. In a recent survey conducted by the October Research Group, more than half of all appraisers said that they personally felt pressured to overstate loans, and "nearly all" said they knew a colleague who had actually done so. The pressure to inflate, October's publisher Joe Casa said, "is much worse now than it's ever been." Industry analysts have estimated that between 15 and 30 percent of houses nationally are over-valued.

It's not just the discipline of banks that keeps people from buying more than they can afford, but also the buyers' own fear and guilt. But in an environment where home prices continue to spiral up, fear and guilt are replaced by a sense that you're a fool not to buy the most house you can possibly get away with.

A particular kind of speculative frenzy ensues, captured in a recent story in *The Washington Post* which detailed a new phenomenon: home buyers camping out overnight for the chance to be the first in the next morning's open house, ready to buy $700,000 houses in built-out, lush-lawned suburbs like Arlington. The phenomenon has created temporary, yuppie tent cities. The story's authors interviewed several buyers in the tented line who planned to sell their purchases back into a steadily rising market, and concluded, dryly: "There is an element of speculation to the lines."

What makes the current frenzy especially dangerous is that every relevant institution has an incentive to play along. Who, after all, is likely to say stop? Not the realtors. Not the banks, any longer. Not Fannie and Freddie or the private secondary-mortgage operators, who are turning vast profits on the backs of the bubble. Certainly not the Federal Reserve or the Treasury Department, while the economy depends on a sustained housing boom.

By 2000, some acute observers, like Jane D'Arista, a former chief economist for the House Financial Services committee and now a federal funds researcher with the Financial Markets Center, had begun to warn that the situation was untenable. By 2002, a few major players, like Steve Roach, Morgan Stanley's chief economist, had picked up on the concerns about a bubble and Fannie and Freddie's sprawling influence. But Greenspan, Treasury, and GSE officials, in interviews and testimony, denied that housing inflation posed a problem. And, sure enough, in the next year, not only did the bubble fail to deflate, but it also expanded—the housing sector posted its best year ever.

Then, last summer, came a warning no one should have missed: news of major accounting fraud at Freddie Mac. In stocks, corporate accounting scandals appeared after the market plunged, too late to signal danger. But the fraudulent accounting at Freddie Mac was, or should have been, a wake-up call, though the details of this scandal were distinctly different. Instead of hiding losses, as happened at Worldcom and Enron, the accountants at Freddie Mac had been hiding embarrassingly large profits. They feared that higher-than-expected returns might incite more risk-taking and a more volatile housing market than investors in Freddie Mac would like. A number of senior executives were canned, and spooked foreign investors sold off Freddie and Fannie's debt. A sense was emerging, among politicians as well as economists, that Fannie and Freddie were not just running amok, says Tom Stanton, an attorney specializing in government sponsored enterprises, but that they "were showing a combination of high leverage, fast growth, and weak oversight of just two companies that held or guaranteed several trillion dollars of mortgages between them and posed potential systemic risk to the American economy."

Testifying before Congress on July 16, Greenspan did not discuss any of this, nor did he mention a bubble. Instead, he chose to praise the economic benefits of low interest rates and home refinancing. The boom continued unabated. By October, homebuyers were able to refinance to a 30-year fixed-rate loan with a rate of just 4.99 percent.

Eleventh-hour warnings

Still, the accounting scandals, carrying with them a vague, unsavory whiff of Enron, made reforms in the housing market impossible to ignore. Even Franklin Raines, Fannie Mae's chairman, admitted that the GSEs needed to be reined in. In the fall, the House dipped its toes into the water, with a bill that established a single regulator in the Treasury Department with broader authority to make sure the GSEs had their finances in order. At the White House's behest, the Senate Banking Committee began hearings on the same issue in February. The goal of most of the debate in Congress has so far been how to ensure the GSEs financial viability; there has been very little talk about how to reduce their role in the housing markets.

That job fell to Greenspan: Finally, on Feb. 24, testifying before the Senate Banking Committee, he came clean about the risks of the housing market, in a speech reminiscent of his 1996 warning about "irrational exuberance" in the stock market. In his familiar, glum posture, his bald head slouching low over the table, he warned that the GSEs weren't just unstable, but also posed a "systemic risk" to the economy of the United States. He suggested debt caps, to reduce Fannie and Freddie's role in the market, and urged stricter regulation.

The chairman's proposals were both brave and right, the best plan for resolving the structural problems with GSEs that's been put forward yet. But given the political situation, his reforms won't be enacted anytime soon. The day after his testimony, his suggestions were brushed off by everyone from Fannie and Freddie's chief executives to Republicans and Democrats on the Hill. Oh, it's just Greenspan.

Both political parties have bought into the idea that a vast, unfettered Fannie and Freddie are good for the country, and have only amplified the GSEs' "American Dream" rhetoric. Republicans are still invested in the deregulation of Fannie and Freddie they helped engineer in the late 1980s. Democrats, generally the party of more regulation, have historically been Fannie and Freddie's best friends, and the GSEs' lush executive suites are packed with former Democratic staffers: Raines was Clinton's director of the Office of Management and Budget, and his predecessor, James A. Johnson, a longtime aide to Walter Mondale, is now leading John Kerry's search for a running mate. In the hearings on the Hill, neither Democrats nor Republicans have seemed favorably disposed to strict regulation of Fannie and Freddie, and American Banker has concluded that the GSEs' lobbying power is strong enough that no regulatory bill will pass without their okay.

Greenspan, of course, knows all this. He knows his reform initiatives stand little chance politically right now, and he knows that even if, miraculously, they were put into place, they likely won't keep the housing market from crashing. Why even bother to bring it up? Two reasons, say Fed-watchers. First, though he didn't explicitly warn against the housing bubble, Greenspan wants to be able to claim, after the bubble bursts, that he gave fair warning, even though these warnings came at the eleventh hour. But at a less cynical level, the chairman knows that in the American political process real reforms only get put into place after a crisis and not before, but that you stand a better chance of getting them if you publicize them early.

So, why then didn't he bring these issues up even earlier? The answer may be that he simply couldn't afford to—he was relying on a supercharged housing sector to get the economy as a whole through the recession. Indeed, he still is. On the very day that he suggested his reforms of the secondary market, he was trying to squeeze a little more juice out of refinancing with his bizarre advice to consumers about ARMs. And that, ultimately, is the ironic and uncomfortable position that this economy has forced

Greenspan into. To get out of the recession, he had to rely on, stay mum about, and even encourage a housing bubble. Now, that very bubble may be the thing that destroys the recovery he has sought to create.

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