

MBA07

▶ REGISTER

Economist.com Spring 2007 MBA and Executive Education Fair

March 30th 2007

www.economist.com/mbafair

Organised by

Economist Inte

Visit MBA Schools | Participate in live Q & A sessions

Economist.com**OPINION
LEADERS**

PRINTABLE PAGE VIEW SPONSORED BY

[About sponsorship](#)

Housing markets

The trouble with the housing market

Mar 22nd 2007

From The Economist print edition

After the great global housing binge, the hangover is kicking in. Especially in America

James Fryer



JUNE is National Homeownership Month in America. National Foreclosure Month would be more apt. Some corners of the mortgage market—notably “subprime” loans aimed at those with poor credit records—have a nasty case of dry rot. One subprime borrower in eight is behind with the payments. As the introductory “teaser” rates on more loans expire and monthly payments outrun the means of more borrowers, hundreds of thousands of Americans are set to be thrown onto the street.

Only a few weeks ago you could find voices claiming that the worst was over for America's sagging housing market. That is harder now. Although it is too soon to be truly gloomy about the broader economy, any structural surveyor would spot tightening credit and a glut of housing supply. The foundations are not much better: falling house prices are no good for consumer spending, which has been propping the economy up (see [article](#)).

Other countries may also be looking nervously at America. And about time. An American recession would scarcely be welcome—even if for the moment Asian and European economies seem to be doing nicely on their own account. However, the true cause for concern is that just as America's housing boom was part of a synchronised global binge on cheap money, its bust may be part of a global story too.

After a long, long night on the tiles

Listen around the world and you can hear echoes of America's difficulties—even if prices have not yet started to tumble. Start with subprime borrowers. In America these people are, not surprisingly, poorer (and less likely to be white) than those who can obtain mortgages at lower, usually fixed rates. They tended to join the great housing-market party late, when prices were already sky-high. Many appear to have been encouraged to take out loans by brokers more bothered about their fees than their clients' ability to repay their debts. And the lenders who advanced the money—dozens of which have had to shut up shop—underestimated the rate of default. Generously, you could ascribe this to the relative youth of the subprime market. Less generously, you might point to the effect of “securitisation” on lenders' incentives: knowing that loans could be lumped together and sold, and then chopped, repackaged and sold again, made for slack judgment.

To Britons, much of this will sound alarmingly familiar. “Self-certification” mortgages (translation for Americans: “undocumented” or “liar” loans) and interest-only loans have become more common as borrowers, especially young ones hoping to buy their first home or neophyte landlords who think that a string of properties will be their pensions, stretch their budgets (see [article](#)). In Spain lenders are courting the country's army of young immigrants, who often have short or patchy credit histories—and often, it seems, work on building sites themselves.

The other American theme is that homebuyers and lenders are reaping the consequences of loose monetary policy. When the Federal Reserve cut interest rates after the tech bubble burst, it inflated another, in housing. In Europe you can see a similar story. The single currency has brought the euro area's star performers, Spain and Ireland, unsuitably low interest rates—and house-price increases of 180% and 250% respectively in the past decade. Now both look too dependent on housing. In Spain, where the rate of house-price inflation has eased—eased—to 9% or so, housing investment now accounts for 7.5% of GDP. Were this ratio to fall to, say, 6%, still above the average for the rest of the euro area, job losses in building could cut employment growth by a percentage point a year.

Ireland looks rockier still. Housebuilding accounts directly for a staggering 15% of national income and 12% of employment. Whereas prices have soared, rents have stagnated in recent years and, at 4%, rental yields in Dublin do not cover even the cost of borrowing. Now prices are flattening too. According to Morgan Kelly, of University College, Dublin, to return the ratio of prices to rents to where it was around 2000, real prices will need to fall by 40-60% in the next eight or nine years.

What next?

Americans and others may be tempted to take heart from apparent soft landings in Britain and Australia. That would be a mistake. Admittedly Britain's housing market has had a second wind since a surprise interest-rate cut in 2005. But the effects of rate increases since may not have come through yet. And Australian prices have undergone huge regional variations. Buy-to-let investors in Sydney flats, who saw prices drop, may think their landing rather bumpy.

Inevitably, Americans will ask what policymakers can do. It is too late to unwind monetary policy of a few years ago; cutting rates now risks compounding the error. The Fed's main worry is inflation—and rightly so. Given the slackness of lending standards, especially in the subprime market, there is an argument for tighter oversight of non-bank mortgage companies, and at the federal rather than state level. It is tempting to blame securitisation for much of the mess. But the technique has been a boon, by and large, making credit markets of all sorts more liquid. And despite the arrears and foreclosures, subprime lending has been part of what Alan Greenspan once called a democratisation of credit. More Americans are able to borrow and buy houses. Most manage.

The economic consequences may yet be large; so may the political ones. Most of the gains from America's recent economic success have been scooped by those at the top of the pile— not least in the financial industry. Now many lower down face unpayable debts and the loss of their homes.

Populist politicians may well make much of the contrast between a second house in the Hamptons and no house at all. Instead, they should stop making a fetish of homeownership. That people are free to borrow to buy their own home, should they wish, is fine. That politicians should encourage homeownership for its own sake is not. That they foster it with tax breaks, as they do in America, is daft.

Copyright © 2007 The Economist Newspaper and The Economist Group. All rights reserved.