

Financial Crisis and the Housing Market

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Well, I thought I would bring things down to earth a little and talk about housing, since the problem started with the housing market and the financial structure that was built on the housing market. I thought I would take a look at what's going on with the housing prices, housing construction, building permits and see whether we're anywhere close to working this thing through. I would guess that until housing straightens itself out, there's still danger of trouble for everything else. So let's take a look at the housing market.

There wasn't a problem at the start. I think these speculative bubbles often get started for good reasons. There were good reasons to think that the prices of housing ought to be rising. We went through a very long expansion in the 1990s and homeownership rates were going up. The Federal Reserve reduced interest rates a whole lot with the recession of 2001, so much so that housing starts never took a hit at all. Usually housing construction drops off a lot in a recession, but not in 2001. Out on the coasts and in some of the big cities, we had a population growth, which adds to the demand for housing. We had zoning restrictions in those places, which restricts the supply of houses. We had a lack of what is called, other than in the ag school, "open space" in some of those places. Indiana's open space helps explain why we never did experience that bubble in housing prices. Now what happened was that in 2001 and in the beginning of 2002 people started noticing that these asset prices are going up and start figuring that this was a good way to make a profit. We started seeing all those television shows about flipping houses, and we started seeing those crazy prices in California that are always hard for us to believe here in Indiana. By early 2006 the price adjusted for inflation of houses across the 10 biggest markets in the U.S. had risen by 60 percent, 60 percent in four years. And that's where it peaked, in early 2006. What stopped it? It's tough to say what stops one of these speculative bubbles, but what did stop it? For one thing the Fed increased interest rates and mortgage interest rates went up. That restrained demand. Second there was probably an awful lot of speculative home building which inflated supply. Add those two things together and people start noticing that it's taking longer and longer to sell the houses they're trying to flip, or longer and longer to sell the house so you can move into a bigger one. Essentially the quantity supplied outstripped the quantity demanded at the going price and so that's when the price started to fall in the beginning of 2006. I can tell you that by some measures it looks like we are about 2/3rds of the way back to where we were at the end of 2001 and beginning of 2002. At the rate that the real price of housing is declining it will take another year to get back to where we were in 2001 when the last recession ended. I don't know if it has to stop there but I would say we've got at least another year of housing price decline before quantity supplied and quantity demand are equated and the housing price can stop falling. What does that mean? For the financial sector, all these investors who have assets that are based on people paying mortgages are still not going to know what their assets are worth, because declining home prices tend to contribute to default. If we also have a recession a lot of people who are in these houses may not be able to pay on those mortgages. And because their houses are worth less than they owe, many of them may default. So I think we've got a problem that's a least likely to go on for another year. Now a month ago, I was

actually fairly optimistic about the real side of the housing market--home construction and home sales. If you looked at housing starts, building permits and home sales, they seemed to have bottomed out. They had been declining rapidly for two or three years, but in the first six months of 2008, building permits quit declining, housing starts quit declining and housing sales quit declining. Then the August numbers came out and they all started declining again. Maybe this credit crunch has started to affect the housing market. So we've got another perfect storm here. The asset problem created in the housing market created difficulties in the credit markets, and are now feeding back into the housing market and creating further problems there.

One other indicator that I like to look at is the spread in interest rates between the three month treasury bill and the three month commercial interest rates. I like this one for a couple reasons. One is that I understand it and that's not always the case with this financial stuff. When things go bad people don't want to lend in private markets. People want to lend to the Treasury because the U.S. Treasury has never missed an interest payment in some 200 plus years. Money gets shifted out of the private market and into the public markets. When people get scared the private market rate goes way up and the public market rate goes way down, so the spread between those two increases. That increase is a nice indicator of credit crunches and also a leading indicator of recession. And the other reason I like that indicator is because I first discovered it in an article written in 1990 by an economist from Princeton named Ben Bernanke, and what's in Bernanke's head is of interest to all of us these days. The spread does a good job in pointing out credit crunches. There's one back in 1990-91 during the savings and loan crisis. There's another credit crunch in October of 1998, during the East Asian financial crisis. Over the last year, the spread between those two interest rates has been higher, a lot higher than it was during either of those two episodes. It's been up in the neighborhood of about 1.8 percentage points, whereas back in the '98 it peaked at only 1.2 percent. The spread is much higher now, and it's been higher longer than either of those earlier episodes. The St. Louis Fed, by the way has a wonderful website that has all this data. They've got it updated through Oct. 1, which was last Wednesday. On that day the treasury rate was 0.85 percent, the commercial rate was 3.81 percent, so the spread between the two was 2.96 percent. Remember the highest monthly spread we've had was 1.8, so something was going on in the markets last week. And I think if you look at numbers like that you can understand why Mr. Bernanke and Mr. Paulson were pushing so hard for that bailout bill. One other interesting note, since Oct. 1, the three-month Treasury rate was down at 0.62 percent and that was the lowest rate since June 1954. These are events to take note of.