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The Global Impact of America's Housing Crisis

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CAMBRIDGE – The bursting of America's housing bubble in the summer of 2006 triggered the global financial crisis and recession. The sharp fall in house prices that followed caused a dramatic downturn in household wealth, leading to lower consumer spending and an overall fall in GDP. By now, wealth in the form of owner-occupied housing is down about 30%, equivalent to a loss of more than $6 trillion of household wealth.

The fall in house prices also led to a sharp rise in mortgage defaults and foreclosures, which has increased the supply of homes on the market and caused house prices to fall further. As a result, one-third of all American homeowners with mortgages are already "underwater" – their mortgage debt exceeds the value of the house. For one-sixth of these homes, the debt is 20% higher than the price of the house.

In addition, high loan-to-value ratios in the US interact with household financial problems to increase the number of defaults and foreclosures. More specifically, the rising unemployment rate, along with the large number of employees on involuntary part-time work, has increased the number of people who cannot afford their monthly mortgage payments.

Unlike virtually every other country, US residential mortgages are effectively "no recourse" loans. If a homeowner stops making mortgage payments, the creditor can take the property but cannot take other assets or a fraction of wages. Even in those states where creditors have the legal authority to take other assets or wage income, the personal bankruptcy laws are so restrictive that creditors don't bother to try.

Although it is tempting to think of this as a purely domestic problem affecting the United States, nothing could be further from the truth. When homeowners default, banks lose money, and uncertainty about the extent of future defaults undermines confidence in banks' capital, making it more difficult for them to raise funds and causing them to reduce their lending in order to conserve existing resources.

As a result, the recession has been deeper and longer than it would otherwise have been. The resulting weakness of the US economy will mean lower US import demand. And, if the downward spiral in house prices continues, the value of mortgage-backed securities held by financial institutions around the world will continue to decline, affecting the supply of credit far beyond the US.

Some recent data suggest that the decline in house prices may be coming to an end. The rate of decline of US house prices fell in the past three months for which we have data (ending in May), and the figures for May show essentially no decline at all. If that trend continues, it will prevent further erosion of household wealth and strengthen the banks' capital positions.

But the recent data, while encouraging, may be the result of temporary factors rather than an indication that the fall in house prices has actually come to an end. Mortgage interest rates fell below 5% in March and April, but have risen significantly since then. Moreover, a government program of subsidies to first-time homebuyers may have released a backlog of pent-up demand. And banks had a voluntary moratorium on foreclosures, holding supply off the market.

All of this may have caused a temporary improvement in house prices. In short, we will have to wait for the data on house prices in June and July to know whether there has been a permanent turnaround.

The recent rise in existing home sales in the US may also be misleading, since a large proportion are sales of foreclosed properties. Indeed, property that has either been foreclosed or is on the verge of foreclosure now accounts for nearly one-third of all existing home sales. Foreclosed property is generally sold at auction, guaranteeing that there will be a buyer – but driving down prices. Significantly, foreclosures rose 7% month on month in June, and a whopping 32% compared to June 2008.

The Obama administration has enacted legislation aimed at helping individuals who are having difficulty making their monthly mortgage payments because of a decline in their incomes or a rise in the interest rate on their mortgage. For individuals with high monthly mortgage payments relative to their disposable income, the US government will share with the creditor bank the cost of reducing the monthly payment to 31% of disposable income.

This is a new program, and it remains to be seen how well it will work to prevent future defaults. Some limited previous experience with mortgage modifications is not encouraging. Nearly 50% of those who had their mortgages modified nevertheless defaulted within six months.

Unfortunately, there is no program to deal with the defaults and foreclosures caused by high loan-to-value ratios. Given the large number of negative-equity homeowners, there is a risk that defaults and foreclosures will continue. If they do, the sale of foreclosed properties will continue to depress house prices, reducing household wealth and hurting financial institutions.

Unless house prices have stopped declining, it is important for the Obama administration to turn to the problem of high loan-to-value ratios. That would help not only the US economy, but also the economies of all of America's trading partners.

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