

The Great Meltdown of '07
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April, 2007

It's not the end of the world. In fact, you can't even see the end of the world from there. But it's pretty darn worrisome. I refer, of course, to the implosion of the mortgage market taking place during this year. The symptoms are patently obvious: mortgage companies failing, foreclosures rising, and Congressional concern (Note to readers: Congress becomes concerned not because there are real problems, but because it receives a lot of letters and e-mails about a particular issue). Could we have seen this coming? Yes. Could we have prevented it? Yes. Can it be solved? Again, yes.

This state of affairs is a product of many hands. The roots of the crisis go to one of the most basic emotions in the real estate market: greed. In the great housing boom, no one wanted to be left out, and everyone wanted to make as much money as possible. So, consumers looked to buy as much house as they could get. The mortgage industry, ever eager to service (and you can interpret this word as you wish) consumers invented instruments that allowed the purchase of more house than would otherwise be possible. Interest only mortgages, payment option ARMs, and other exotic instruments became quite common, especially in higher price areas like California and Florida. This, in turn, drove price higher as the bidding escalated and produced more frequent use of exotic mortgages. The final piece of this was the occasional overstatement of income by consumers in order to qualify for larger loans.

The crisis is also an example of the law of unintended consequences. The Federal government, since 1993, has sought to expand homeownership. This was done by using Fannie Mae and Freddie Mac to lower the barriers to ownership for lower income buyers through no documentation, low interest rate loans. This brought into the ownership cadre relative unsophisticated debtors, who often made bad choices of mortgage instruments.

A bit of the responsibility for the current problem must be borne by real estate professionals, as well. As de facto mortgage counselors, many agents abetted the greed of buyers by searching out the cheapest monthly payment and accepting whatever buyers wished to represent as their financial condition. After all, with sellers profiting from higher prices, why not go for higher commissions?

Now we have over \$1 trillion loans repricing this year, about 10 percent of mortgage debt outstanding. The overwhelming majority of affected homeowners still have sufficient credit and equity in their homes to be able to refinance to a new variable mortgage. They will be OK but will still sustain higher monthly payments since introductory rates today are higher than they were in 2002 (not to mention the fact that their houses are assessed at higher values, so property

taxes are higher, further pushing monthly payments). Others will be unable to adjust and will be forced into foreclosure.

For the real estate market, there will be two major consequences. First, the glare of adverse publicity, already strong because of the slowdown in sales volume and prices, will intensify as foreclosures rise. The absolute numbers will be small relative to debt outstanding (e.g., a rise from a foreclosure rate of 1.25 percent to one of 2.5 percent), but the percentage change will be broadcast in headlines in all the media ("Foreclosure rates double!!!"). Secondly, regulators will come down hard on the lending industry, sharply increasing qualifying standards for loans and eliminating exotic mortgages. This will make it harder for buyers and retarding the recovery of the housing market. Tougher standards will probably reduce 2007 sales by about 250,000.

The larger impact of the problems in the mortgage market will fall on the economy as a whole. Most of those facing higher mortgage payments will adjust. Their adjustment will come in the form of reduced consumption of other goods. House payments are higher, so the car has to last another year, dinners out are less frequent and less expensive, rented DVDs replace trips to the theater. Since consumption is two-thirds of GDP, this means a lower growth rate for an economy that is already underperforming. Alan Greenspan's alarm over the possibility of recession looks a little more pressing now.

Economists like to say that there is no free lunch. We thought we had it a few years ago: ever-appreciating houses paid for by mortgages which demanded low payments. Well, we feasted then and we're paying now. We hope it's not an exorbitant price.