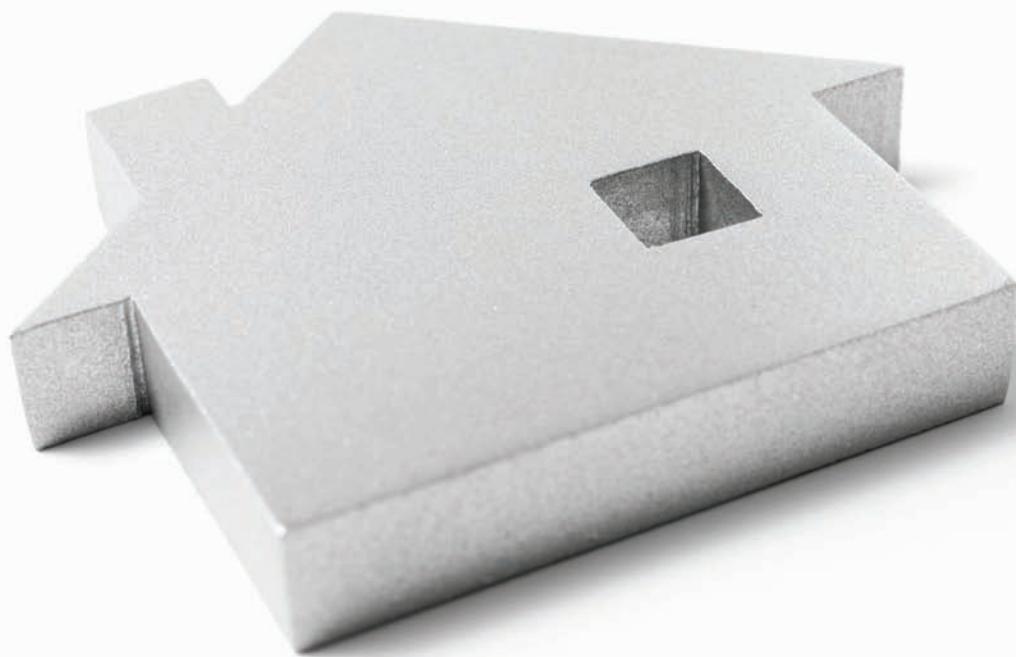


WHITE PAPER

Bold Government Can Solve America's Housing Crisis



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REPORT 1884

Bold Government Can Solve America's Housing Crisis

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America's housing market problem is fairly simple. Somewhere between one and two million vacant homes need tenants.

In some communities, vacant homes are not being cared for, deteriorating the quality of the surrounding neighborhoods. This is causing further price declines, which lead to more foreclosures. The fact is supply is running far ahead of demand. What has to happen for the national housing market to stop falling? We need to decrease supply and increase demand. This can be done in four stages.

First, we must curtail the supply of new homes in the market. Virtually everyone agrees that falling home prices are at the center of the current economic and financial crisis in our country. Why are new homes still being built in cities where prices are collapsing and foreclosures are skyrocketing? Even in places like Detroit and Sacramento where foreclosures are at the highest levels, thousands of new homes are still being built.

In the first nine months of 2008, 2,825 new home building permits have been issued in Sacramento and 1,528 in Detroit. When new homes are built in challenged markets and sold with massive price concessions, prices for all homes in the community trend downward.

Second, we have to slow the supply of homes coming back into the market through foreclosure. To this point, government efforts to do this have not worked. It appears the FDIC plan used to mitigate losses at IndyMac Bank offers a workable solution. FDIC Chair Sheila Bair is emerging as the new thought leader in this arena.

Simply "helping people stay in their homes" has disturbing repercussions. If you are 90 days delinquent in your mortgage and the government reduces the principal amount of your mortgage and lowers your mortgage payments significantly, what incentive do you have to get back on track? Only the stigma of bankruptcy and foreclosure will limit that trend.

If one homeowner in your neighborhood gets lower principal and lower payments, wouldn't the other five owners on your block want the same thing? And the fact that the government is willing to consider "freezing interest rates on mortgages" and "cramming down principal" is not going unnoticed by bond investors.

Suppose you invested your grandmother's savings in mortgages that were expected to pay her 2 percent for two years and then 6 percent for the next eight years. One day you read in the newspaper that Congress is considering freezing the interest rate at 2 percent. Then you note that the chairman of the Federal Reserve is encouraging banks to write down principal balances on mortgages. Now grandma

will be lucky to get 2 percent for the life of her bond and then \$700 in principal back. Will you and grandma want to buy any more of these bonds?

Third, we have to increase demand for houses, and we have to do it quickly. What are we waiting for? How long do American homeowners have to be punished before the government will step in and help stave off a larger catastrophe as house prices continue falling? How can the government do that?

Simple. It needs to give investors an incentive to purchase vacant homes and rent them to tenants. With solid mortgage underwriting standards, investors can buy these homes. There must be adequate down payment so the investor has a big incentive to keep the house. This can be done by lowering the depreciation schedule for investors who buy foreclosed houses to around five to seven years. If we really want to solve the problem quickly, offer these investors zero percent capital gains tax if they hold the properties for more than five years.

Tax policy is frequently used by the federal government to modify behavior in America. A similar tax incentive was given to all businesses after Y2K to buy computers and software because of an acute lack of demand.

By getting these vacant homes into the hands of private American citizen owners, people will have an incentive to keep the lawns mowed and the windows from being boarded up. This will help staunch the decrease in neighborhood values resulting from lack of upkeep.

Fourth, mortgage rates are way too high. Over the past ten years, the 30-year mortgage rate has been priced somewhere around 1.5 percent higher than the ten-year Treasury rate. The ten-year treasury rate has been around 3.7 percent in recent weeks. This means that under normal circumstances everyone in America should be able to get a 30-year mortgage for about 5.2 percent.

Unfortunately, mortgage rates have been much higher than that. Why? In my opinion it's due to a complete lack of confidence in the financial integrity of Fannie Mae and Freddie Mac.

The government has now nationalized these two institutions. Why not go ahead and make the government guarantee on "FRANNIE" bonds explicit? Just tell the world that, for the foreseeable future, FRANNIE mortgage bonds are guaranteed by the full faith and credit of the U.S. government. This would drop mortgage rates substantially and let all Americans refinance their homes at a very low rate.

On Nov. 20, the ten-year treasury rate dropped to 3 percent. This should create an opportunity for all Americans to refinance with a 30-year mortgage around 4.5 percent. Everyone knows that the federal government "implicitly" was behind FRANNIE bonds. Now that they have been nationalized, make the guarantee explicit.

No matter how complex this situation appears to be, it can be reduced to supply and demand. In the housing market, we've got too much supply and inadequate demand. We need public policies that address these fundamental wounds in the U.S. economy. Simply printing money is a temporary bandage that merely delays the inevitable.



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